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EMPLOYEE BENEFITS DEVELOPMENTS AUGUST 2008

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Practices & Industries

Employee Benefits

ESOP Dividends – New Tax Reporting Rules
For a C corporation, a deduction is allowed for any Internal Revenue Code (Code) Section 404(k) dividend paid in cash by the corporation during the taxable year with respect to applicable employer securities held by an employee stock ownership plan (ESOP) maintained by the corporation or by a related corporation. A 404(k) dividend generally is any dividend that, in accordance with the provisions of the ESOP, is paid directly to ESOP participants or their beneficiaries; is paid to the ESOP and is distributed in cash to plan participants or their beneficiaries within 90 days after the close of the plan year in which paid; or is, at the election of plan participants or their beneficiaries, paid to such participants or their beneficiaries or paid to the ESOP and distributed in cash to such participants or their beneficiaries within 90 days after the close of the plan year in which paid. Section 404(k) dividends are not subject to the 10% additional tax on early plan distributions, are not eligible rollover distributions, are not subject to withholding under Code Section 3405, and are not taken into account in determining if Code Section 401(a)(9) required minimum distributions have been made.

Distributions of 404(k) dividends from an ESOP that are made in 2009 or later years will have to be reported on an IRS Form 1099-R that does not report any other distributions. Accordingly, if there are other distributions from the ESOP beginning in 2009 that are not 404(k) dividends, they must be reported on a separate Form 1099-R. It is anticipated that the instructions will require a special code in Box 7 of Form 1099-R to indicate the special tax treatment and rollover restrictions applicable to 404(k) dividends. Payments of 404(k) dividends made directly from the corporation to the plan participants or their beneficiaries are reported on Form 1099-DIV. (*IRS Announcement* 2008-56)

Mere Posting of SPD on Intranet Does Not Ensure Actual Receipt
Many employers today seek to reduce the cost of printing and delivering summary plan descriptions (SPDs) by posting the SPDs on employer intranet sites or by other electronic means. A recent case reminds us, however, that there are specific requirements that need to be followed if an employer wishes to furnish SPDs and other forms of ERISA disclosures electronically. To deliver SPDs and other disclosures electronically, the administrator, among other things, must take appropriate measures reasonably calculated to ensure that the electronic method of

delivery results in actual receipt of the SPD. In a case heard by the Ninth Circuit Court of Appeals, the court found that the administrator failed to show it properly furnished an employee with a copy of the employers disability plan SPD because the administrator "had submitted nothing on the record to suggest that the mere placement of an updated SPD on [the employer's] intranet site could ensure [the employee] would actually receive the information." As a result, for purposes of defending a claim for disability benefits, the administrator could not rely on language in the electronically posted SPD that unambiguously conferred on the administrator discretionary authority to determine eligibility for benefits and to construe the terms of the plan. (*Gertjejansen v. Kemper Ins. Co., 9th Cir. 2008*)

Trilogy of IRS Guidance Regarding Health Savings Accounts

Recent guidance issued by the IRS in the form of Notices 2008-51, 2008-52, and 2008-59, provides important guidance on health savings accounts (HSAs), including guidance on:

- tax-free transfers from IRAs and Roth IRAs to HSAs,
- contribution limits for employees who become HSA-eligible mid-year,
- health coverage an otherwise HSA eligible individual can have without losing his or her HSA eligible status, and
- circumstances under which employers can recoup mistaken HSA contributions.

Background. An HSA is a tax-exempt custodial account established for the purposes of paying qualified medical expenses. Employers, employees, and others may contribute, tax-free, to an individual's HSA within specified limits. For 2009, the annual limits are $3,000 for individuals enrolled in single coverage and $5,950 for individuals enrolled in family coverage. Distributions are tax-free if used to pay qualified health care expenses. An employee can establish an HSA if he or she is an HSA eligible individual. An individual is HSA eligible if he or she is covered by a qualified high deductible health plan (HDHP), has no other health plan coverage (with the exception of certain plans providing certain types of limited coverage), is not enrolled in Medicare, and may not be claimed as a dependent on another person's tax return. An HDHP is a health plan that satisfies certain requirements with respect to deductibles and out-of-pocket expenses. For 2009, the minimum deductible may not be less than $1,150 for single coverage and $2,300 for family coverage. Notice 2008-51. HSA eligible individuals are entitled to make a one-time tax-free transfer from their IRAs or Roth IRAs to their HSAs.

Notice 2008-51 provides detailed guidance concerning these types of transfers, referred to as "qualified funding distributions." A qualified funding distribution may not exceed the maximum HSA contribution for the year reduced by any other contributions to the individual's HSA for that year. A qualified funding distribution is neither includible in income nor subject to the 10% penalty tax for early IRA withdrawals, provided the individual remains HSA eligible for each of the 12 months following the month in which the qualified funding distribution is made. For example, if an individual receives a qualified funding distribution on February 10, 2009, the individual must remain HSA eligible through February 2010. The notice confirms that employees who cease to be HSA eligible during this period are required to pay tax on the qualified funding distribution in the year they cease to be eligible. The 10% penalty tax may also apply. Employers who maintain HDHPs are not required to ensure that these transfers qualify; compliance is the responsibility of the employee. However, employers who wish to assist employees in properly structuring these transfers will want to consult Notice 2008-51.

Notice 2008-52. In this notice, the IRS explains the contribution limits for employees who become HSA eligible mid-year. An individual's maximum HSA contribution for a year is the greater of the following two amounts:

- Pro-rated Contribution Limit. One-twelfth of the annual limit multiplied by the number of months for which an individual is HSA eligible.
- Full Annual Contribution Limit. The maximum annual HSA contribution based on the individual's HDHP coverage self only or family, on the first day of the last month of the individual's taxable year (December 1 in the case of calendar year taxpayers).

If a calendar year taxpayer is not HSA eligible on December 1, the individual's maximum HSA contribution for the year is the pro-rated contribution limit described in the first bullet above. Note that using the full annual contribution limit will not be tax-effective unless the individual maintains his or her HSA eligibility for each month of the following year. An exception applies in the case of an individual who ceases to be HSA eligible because of disability or death.

The following examples illustrate these rules:

Example 1. Individual A, age 53, enrolls in family HDHP coverage on December 1, 2008 and is otherwise an eligible individual on that date. A is not an eligible individual in any other month in 2008. A's full contribution limit for 2008 is $5,800. The pro-rated contribution limit is $483 (1/12 x $5,800). A's annual contribution limit for 2008 is $5,800, the greater of $5,800 or $483.

Example 2. Same facts as Example 1, except that A contributes $5,800 to his HSA on December 1, 2008 and ceases to be eligible in June 2009. In 2009, A must include in gross income $5,317, the amount contributed to the HSA for 2008 minus the pro-rated contribution limit ($5,800 - $483). In addition, the 10% additional tax ($532) applies to the amount included in gross income because A is not 59 ½.

Example 3. Individual E, age 35, has self-only HDHP coverage and is eligible for the months of May, June, and July 2008. The full annual contribution limit does not apply to E for 2008 because E is not an eligible individual on December 1, 2008. E's contribution limit for 2008 is $725 (3/12 x $2,900).

Notice 2008-59. In this notice, the IRS provides guidance on a number of matters, including guidance addressing the kinds of health coverage an otherwise HSA eligible individual can have without losing his or her HSA eligible status and the circumstances under which employers can recoup mistaken HSA contributions.

Other Health Coverage. As noted, an individual is not HSA eligible if, in addition to HDHP coverage, he or she has certain other kinds of health coverage. The notice confirms that an employee may be covered by a limited purpose or post-deductible HRA that pays or reimburses the employee's share of the premium for the employer's HDHP; it is not necessary for the HDHP deductible to be exhausted before premiums can be paid or reimbursed.

Post-Deductible HRAs and Health FSAs. A post-deductible HRA or health FSA is health care coverage that does not render an otherwise HSA eligible employee ineligible. The post-deductible HRA or FSA pays or reimburses expenses incurred by employees or dependents for qualifying expenses that exceed the minimum annual deductible (for 2009, $1,150

for single coverage, $2,300 for family coverage). In Notice 2008-59, the IRS clarifies that only medical expenses that would have been covered by the HDHP count toward satisfaction of the deductible. In addition, the notice makes it clear that a post-deductible HRA or FSA may reimburse eligible expenses only if the expense is incurred after the deductible has been satisfied.

Erroneous HSA Contributions. Notice 2008-59 describes the circumstances under which employers may recoup erroneous contributions to an employee's HSA. The IRS says that employers may recoup contributions to the HSA of an employee who was never HSA eligible. In addition, an employer may recoup its contributions to an employee's HSA if, due to an error, the aggregate amount contributed is in excess of the maximum annual contribution. In both instances, any amount not recouped by the end of the year in which the contributions were made must be included as wages on the employee's W-2 for that year. The notice points out that an employer generally may not recoup amounts from an HSA except under the circumstances described above. For example, the notice indicates that an employer may not recoup contributions to the HSA of an HSA eligible employee made after an employee ceases to be HSA eligible.

Service by Director as Interim CEO Results in Loss of Tax Deduction for Corporation

Code Section 162(m) generally provides that a publicly traded company may not deduct compensation with respect to "covered employees" to the extent that the compensation exceeds $1 million, unless the compensation meets a permitted exception. Performance based compensation is one of the permitted exceptions. To qualify for the performance based compensation exception, performance goals must be determined by a compensation committee that is comprised solely of two or more outside directors. At issue in Rev. Rul. 2008-32 is whether a director who served as an interim CEO following the current CEO's resignation on January 7 of a particular year qualifies as an outside director. In response to the resignation, a member of the board of directors was appointed as interim CEO and served in such a capacity through December 11 of that year, a little over 11 months. In January of the following year, the director joined the compensation committee. The IRS ruled that the director was a former officer of the corporation and therefore did not qualify as an outside director. Applying the regulations to this specific situation, the IRS held that the director served as the interim CEO for an unspecified period of time and therefore did not fall within the exception under the regulations for employees serving as an officer for a special and single transaction. Because the compensation committee no longer consisted solely of outside directors, the committee would not be able to set performance goals that would qualify for the exception to Code Section 162(m).

IRS Proposes Regulations Regarding "Greater of" Formulas

As previously reported (Employee Benefits Developments, April 2008), the IRS provided a limited period of relief in Rev. Rul. 2008-7 regarding the application of the benefit accrual rules under Code Section 411(b)(1) with respect to plans that provided for a "greater of" benefit formula. This relief was very important to certain cash balance conversions where a greater of formula might apply as a means to transition from a traditional benefit formula to a cash balance formula. Generally, the accrual rules are intended to prevent "back loading" that would occur when a defined benefit plan provides a faster rate of benefit accrual later in the participant's period of service. The relief granted under Rev. Rul. 2008-7 was limited in that it applied to plan years beginning before January 1, 2009. The IRS has proposed regulations that would be effective for plan years beginning on or after January 1, 2009 by allowing plans with multiple benefit formulas, such as "greater of" formulas, to test each formula separately under the 133-1/3% accrual rule. Under the 133-1/3% accrual rule, a participant's accrual in a year may not exceed 133-1/3% of his or her accrual in any prior year. Under the proposed

regulations, all benefit formulas would have to satisfy the 133-1/3% accrual method and the formulas tested separately must be calculated under different benefit approaches. For example, the benefit formulas could be a final pay formula and a career average formula. (*REG-100464-08*)

No FICA Tax Refund On Benefits Never Received

The IRS has advised that retired employees are not entitled to a refund of Federal Insurance Contributions Act (FICA) taxes paid at retirement on the value of their nonqualified deferred compensation benefits, even though the retirees will never receive the full value of their promised benefits. In accordance with Code Section 3121(v)(2), the retirees in question paid FICA tax on the entire accrued value of their benefits in the nonqualified deferred compensation arrangements when those benefits became reasonably ascertainable on their retirement. Because the benefits were granted under unfunded, nonqualified arrangements, the amounts in question were subject to the claims of creditors in the event of the employer's insolvency. Unfortunately for the retirees, their former employers filed for Chapter 11 bankruptcy and terminated their plans, resulting in the cessation of benefit payments. Faced with the loss of their benefits, many former employees filed claims for partial refund of their FICA taxes. The IRS determined that the employees were not entitled to a refund because the FICA tax was correctly imposed at retirement on the amounts deferred under the plans. In the IRS's view, the fact that the employees would never receive the full amount deferred because of their employer's bankruptcy does not give them the right to receive a refund of FICA taxes paid on those benefits that were promised but never received.

In a related finding, the IRS also concluded that the three-year statute of limitations for purposes of submitting refund claims for the employee's share of FICA taxes paid on amounts deferred under nonqualified deferred compensation plans begins on April 15 of the year following the year in which the employee retired and the employer filed the FICA tax return and remitted the appropriate taxes to the IRS. After this three-year limitation period has expired, no adjustment or refund is possible. (*Chief Counsel Advice 200823001*)

Kentucky Retirement System Does Not Violate the ADEA

The Supreme Court recently held that the Kentucky Retirement System (the Plan) does not violate the Age Discrimination in Employment Act (ADEA). The Plan provides that employees are eligible to receive normal retirement benefits after either (i) 20 years of service or (ii) attaining age 55 with five years of service. The Plan calculates normal retirement benefits based on actual years of service. However, the Plan calculates disability retirement benefits by adding to an employee's actual years of service the number of years that the employee would have been required to work to become eligible for normal retirement benefits. These additional years of service are only added if the employee has not already attained retirement age.

The EEOC brought a claim on behalf of a 61-year-old employee who began receiving disability retirement benefits after 18 years of service. The employee received normal retirement benefits based on his 18 years of service because he was over age 55 and eligible for normal retirement under the Plan. However, if he had been under age 55 and not eligible for retirement, he would have received higher disability retirement benefits based on an imputed 20 years of service.

The ADEA forbids an employer to "discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment because of such individual's age." An employee claiming disparate treatment must prove that age "actually motivated the employer's decision." The Supreme Court ruled 5-4 that the Plan did not violate the ADEA because the court concluded that the Plan was not actually motivated by bias against older workers and was instead

designed around the analytically distinct idea of pension status. The court held that when a plan conditions eligibility on age and then discriminates on the basis of pension status, a plaintiff must show that the unequal treatment was actually motivated by age rather than pension status. The plaintiff in this case failed show the Plan design was motivated by age discrimination. (*Kentucky Retirement Sys. v. EEOC, U.S., No. 06-1037*)