EMPLOYEE BENEFITS DEVELOPMENTS JANUARY 2007

Hodgson Russ Newsletter
January 18, 2007

Practices & Industries

Employee Benefits

RULINGS, OPINIONS, ETC.

New IRS guidance on per diem expense reimbursement arrangements
The Internal Revenue Service (IRS) published Revenue Ruling 2006-56, which reminds employers about the need to properly track the amount of expense reimbursement allowances paid to employees on a per diem basis. Generally, employers may reimburse employees for substantiated business expenses without subjecting the reimbursements to income tax or employment tax. For reimbursements of expenses for meals and other incidentals associated with business travel, employees may instead receive an excludable allowance for each day of travel up to the federal per diem rates without having to substantiate the amounts of the expenses. If, however, an employer pays an expense allowance that exceeds the federal per diem rates, the excess amounts are subject to income and employment taxes if they are not repaid to the employer, unless the employee actually substantiates all of the expenses covered by the per diem allowance. Thus, a per diem allowance arrangement that fails to track the excess amounts and does not include the unsubstantiated, unrepaid excess amounts in the employee's taxable income will cause the full amount of the allowances paid under the arrangement to be subject to tax, not just the excess amounts.

Revenue Ruling 2006-56 is effective immediately. However, the IRS is instructing its agents, in the absence of intentional noncompliance, not to apply the results under Revenue Ruling 2006-56 for taxable periods ending before 2007 so that employers have additional time to make changes or adjust their systems to track excess allowances correctly.

IRS issues more 2007 adjustments
The IRS has published two revenue procedures that provide cost-of-living adjustments to various limits and allowances.

Revenue Procedure 2006-49 includes the new 2007 rate for optional standard mileage rates for the business use of cars, including vans, pickups, and panel trucks. Beginning in 2007, the new standard rates are 48.5 cents per business mile, 20 cents per mile for medical or moving mileage, and 14 cents per mile driven in service of charitable organizations. These rates may be used in lieu of an actual allowable expense incurred in the use of a car.

Revenue Procedure 2006-53 sets 2007 dollar limits for maximum contributions to health savings accounts (HSAs), minimum deductible and maximum out-of-pocket thresholds for related high-deductible health plans (HDHPs), and monthly limits for transportation fringe benefits. Annual HSA contribution limits have been increased for 2007 to $2,850 for individual-only HDHP coverage and $5,650 for family coverage. The related HDHP minimum deductible and maximum out-of-pocket limits have been increased in 2007 to $1,100/$5,500 for individual-only coverage and $2,200/$11,000 for family coverage. In order to qualify for making HSA contributions, the minimum deductible is the lowest deductible an HDHP can have, and the maximum out-of-pocket is the most the HDHP can require the covered individual or family to pay for covered medical expenses. For qualified transportation fringe benefits, the 2007 monthly limit for tax-free parking benefits is raised to $215, and the maximum for transit passes and van pooling expenses is $110.

New 2005 and 2006 withholding and reporting rules under Code § 409A

Interim guidance governing the reporting and wage withholding obligations of employers under Internal Revenue Code § 409A (409A) for 2005 and 2006 was released by the IRS in late November. Notice 2006-100 extends the waiver granted in 2005 (Notice 2005-95) of an employer's reporting obligations with respect to annual deferrals of compensation under 409A. Under the extended waiver, employers are not required to report on a Form W-2 (or Form 1099) any amounts deferred under a nonqualified deferred compensation plan for calendar years 2005 and 2006. The waiver does not extend, however, to an employer's obligation to report and withhold on deferred compensation that must be included in gross income. Any amounts that are includible in income for calendar year 2006 because of the failure of a nonqualified deferred compensation plan to meet the requirements of § 409A must be reported and treated as wages for income tax withholding purposes. Only amounts that are actually subject to § 409A need to be included in income under this rule. The notice provides guidance for calculating the amounts that must be included in income under various types of deferred compensation arrangements, as well as for the calculation of interest and penalties imposed under 409A. Similar guidance is provided for employees' income tax reporting and payment requirements for 2005 and 2006.

Employers who relied on a prior suspension of reporting requirements for 2005 and did not report deferrals of compensation includible in income for that year must now file corrected returns and furnish corrected payee statements (Form W-2 or 1099-MISC) for 2005. Employers who comply with the rules set forth in the notice will not be liable for additional income tax withholding or penalties and will not be required to file corrected returns or statements as a result of any future guidance related to amounts includible in income for 2005 or 2006 under §409A.

Transitional guidance for diversification rights

On November 30, the IRS issued transitional guidance pertaining to the new diversification rights of participants in defined contribution plans holding publicly traded employer securities. Under the Pension Protection Act of 2006, defined contribution plans with publicly traded employer securities must notify participants that they may diversify their accounts by divesting employer securities in their accounts and reinvesting an equivalent amount in other investment options under the plan. At least three other diversified investment options must be provided. Under the guidance, a plan may limit the times for divestment and reinvestment to periodic, reasonable opportunities occurring at least quarterly. Except for restrictions related to compliance with securities laws, however, no restrictions or conditions may be imposed on the investment of employer securities that are not imposed on other investment options in the plan. The notice also provides certain transition rules and includes a model diversification notice for employers to provide to participants. Plans with plan years beginning in January 2007 will not be required to provide notices prior to January 1, 2007 (Notice 2006-107). In Field

Assistance Bulletin No. 2006-03, the Department of Labor (DOL) advises that diversification notices should be furnished as soon as possible following January 1, 2007.

New HSA rules effective for 2007

On December 20, 2006, President Bush signed the Tax Relief and Health Care Act of 2006 (the Act). The Act makes important changes to existing HSA-related rules. The timing of the legislation and the many open questions that await IRS guidance combine to make it difficult for employers to determine precisely how the Act impacts plan design. However, removal of the deductible limit on HSA contributions, increased contributions for mid-year enrollees, and Health Flexible Spending Arrangement (Health FSA) grace period relief (all discussed below) are developments that should be addressed as soon as possible to ensure that 2007 HSA contributions are maximized.

The following new rules are effective January 1, 2007:

Health FSA/HRA rollovers are permitted. Employees may fund HSAs with a one-time, tax-free rollover of funds from a Health FSA or health reimbursement arrangement (HRA). Under prior law, Health FSA and HRA account balances could not be transferred into HSAs. This rollover right cannot be exercised more than once and expires on January 1, 2012.

Deductible limit on contributions is removed. Under prior law, the maximum contribution to an HSA for a year was the dollar limit in effect for the year (for 2006, $2,700 for single and $5,450 for family) or, if less, the amount of the deductible in the related HDHP. The Act removes the HDHP deductible limit. For 2007, the maximum contribution is $2,850 (single) and $5,650 (family) regardless of the deductible applicable to the plan in which the individual is enrolled.

Increased contributions for mid-year enrollees. Under prior law, the maximum contribution for a year was pro-rated for individuals enrolling after the start of the year. Thus, if an individual was enrolled for six months of the year, his or her contribution was half the annual contribution limit (e.g., for 2006, $1,350 for single coverage) even if, as usually is the case, the deductible under the high-deductible health plan was not similarly pro-rated. Under the Act, an individual enrolling mid-year is eligible for the full-year contribution, provided certain conditions are satisfied.

Health FSA grace period does not prevent HSA contributions. Before 2007, individuals participating in general-purpose Health FSAs with grace periods could not begin contributing to an HSA until the first day of the month following the expiration of the grace period, even if the individual had a zero balance in the Health FSA at the end of the prior year. Under the Act, an individual covered by a Health FSA with a grace period may contribute to an HSA before the grace period ends if the individual's Health FSA balance is zero before the start of the grace period or any remaining Health FSA funds are transferred to the new HSA.

CASES

Deference to plan sponsor's benefit determination retained, despite use of non-fiduciary TPA

Employers that sponsor self-insured health plans often retain third-party administrators (TPAs) to assist the employer (or other claims fiduciary) with the adjudication of benefit claims submitted for determination as part of a plan's claims procedure. In fact, it is not uncommon for a TPA to actually decide claims, even if the TPA is not the fiduciary to whom the plan assigns this authority and responsibility. If an employer or other fiduciary with claims adjudication authority

permits a non-fiduciary TPA to exercise this authority, will the non-fiduciary TPA's decision to deny benefits be given deference by a court in a lawsuit challenging the TPA's decision (i.e., will the TPA's decision be subject to the usual "arbitrary and capricious" standard of review)? Recently, the United States Court of Appeals for the Tenth Circuit answered this question in the affirmative.
However, there was a well-reasoned and vigorous dissent in the case that argued that benefit determinations rendered by a non-fiduciary TPA should not be given the same deference that otherwise would be given to a decision of the actual claims fiduciary (i.e., should not be subject to an arbitrary and capricious standard of review). Thus, according to the dissent, where a non-fiduciary TPA denies a claim, and that decision is challenged in court, the court could overturn the benefit denial and order payment of the benefit, even if the TPA's decision to deny payment was reasonable. The dissent in this case may serve as a warning that employers and other claims administrators (e.g., benefit committees) should carefully monitor the TPAs claims-review process and participate actively in benefit denials that involve significant benefits. (*Geddes v. United Staffing Alliance Employee Medical Plan*, 10th Cir. 2006)

Cash balance plan controversy continues

While the provisions in the Pension Protection Act of 2006 permitting cash balance plan designs and the favorable decision in the IBM Personal Pension Plan case (See *Employee Benefits Developments*, September 2006) were hopeful signs that the controversy on cash balance plans would come to an end, a recent decision indicated that will not be the case.

In a case involving the JPMorgan Chase Retirement Plan, the United States District Court for the Southern District of New York denied the motion of JPMorgan Chase to dismiss the claim that the cash balance plan design violated age discrimination rules under the Employee Retirement Income Security Act of 1974 (ERISA). In his decision, Judge Baer indicated that two district courts in the 2nd Circuit have found cash balance plans not to be age discriminatory, while one other district court in the 2nd Circuit found them to be discriminatory. Interpreting the anti-discrimination provisions of ERISA, Judge Baer ruled that cash balance plans are age discriminatory based on the statutory language of ERISA. Judge Baer indicated that the result depends on whether one focuses on the employer's contributions (inputs) or the employee's retirement benefit (outputs) under a plan. ERISA's statutory provision refers to a defined benefit plan as being discriminatory if the "rate of an employee's benefit accrual is reduced because of the attainment of any age." Judge Baer's reading of this provision is that the focus must be on the benefit payable at normal retirement age (the outputs) as opposed to the hypothetical contributions being made (the inputs). Because older employees have a shorter period of time in which to receive interest credits under a cash balance plan, the output expressed as an annuity benefit is reduced for older employees.

Judge Baer acknowledges in his opinion the policy arguments in favor of cash balance plan designs and the 7th Circuit's recent decision in the IBM Personal Pension Plan case. However, Judge Baer found the courts must decide these cases based on the existing statutory language, which, in Judge Baer's interpretation, results in the conclusion that cash balance plan designs are age discriminatory. Judge Baer further noted that it would be for Congress to correct this situation and not the courts. While Congress did address cash balance plan designs in the Pension Protection Act of 1986, it did so only on a prospective basis and does not address situations prior to June 29, 2005.

While there has been good news on cash balance plan designs, we can expect that litigation on cash balance plans existing prior to June 29, 2005 will continue outside of the 7th Circuit. (*In re J.P. Morgan Chase Cash Balance Litigation*, S.D.N.Y., 2006)

Prescription drug abuse amounts to gross misconduct for COBRA purposes

An employer is not required by the Consolidated Omnibus Budget Reconciliation Act (COBRA) to offer continuation of health benefits to an employee who has been terminated for gross misconduct. The COBRA statutes and regulations do not define the term "gross misconduct," and courts have not provided clear standards as to when it is proper to apply the gross misconduct exception. As a result, employers often are reluctant to invoke the gross misconduct exception to COBRA out of fear of a lawsuit and potentially severe penalties for misapplying the gross misconduct exception. In a recent case, an employer tempted fate by relying on the gross misconduct exception and denying COBRA rights to an employee who the employer terminated for poor job performance stemming from repeated episodes of prescription drug abuse. The terminated employee sued the employer for failure to provide a COBRA election notice. In this instance, however, the court sided with the employer and ruled the employer had properly applied the gross misconduct exception. According to the court, the employee's continued misuse of her prescription medications (which both endangered the employee and created an unsafe work environment) deliberately violated the employer's standards of conduct and qualified as gross misconduct. Nevertheless, employers should still be cautious before invoking the gross misconduct exception. (*Boudreaux v. Rice Palace, Inc.*, W.D. La. 2006)