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EMPLOYEE BENEFITS DEVELOPMENTS JANUARY 2015

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RULINGS, OPINIONS, ETC.

IRS Publishes FAQs Regarding Rollovers of After-Tax Contributions. In the December 2014 issue of *Employee Benefits Developments*, we reported on IRS Notice 2014-54, which allows participants to direct and allocate after-tax and pre-tax amounts that are simultaneously disbursed to multiple destinations. In response to a number of questions submitted to the IRS following the issuance of Notice 2014-54, the IRS published FAQs to assist taxpayers in applying the notice. The FAQs provide the following clarifications:

- A taxpayer *may not* roll over just the after-tax amounts in a retirement plan account to a Roth IRA and leave the remaining amounts in the plan (i.e., take a partial distribution of just the after-tax amounts). The guidance provided in Notice 2014-54 does not alter the requirement that each distribution from a plan must include a proportional share of the pre-tax and after-tax amounts in the account. A taxpayer cannot take a distribution of only the after-tax amounts and leave the pre-tax amounts in the plan. If a taxpayer wishes to roll over all of the after-tax contributions allocated held in his or her plan account to a Roth IRA, the taxpayer could take a distribution of the full amount (all pre-tax and after-tax amounts) in the account, roll over all the pre-tax amounts in a direct rollover to a traditional IRA or another eligible retirement plan, and roll over all the after-tax amounts in a direct rollover to a Roth IRA.
- A taxpayer *may* roll over the after-tax contributions amounts in a retirement plan account to a Roth IRA and roll over earnings on those after-tax contributions to a traditional IRA. Earnings associated with after-tax contributions are considered pre-tax amounts. Thus, after-tax contributions can be rolled over to a Roth IRA without also including earnings. All pre-tax amounts in a distribution (including earnings on after-tax contributions) may be rolled over to a traditional IRA, in which those pre-tax amounts will not be included in income until distributed from the IRA. (IRS Employee Plans News, Dec. 23, 2014)

Agencies Issue Proposed SBC Regulations. On December 30, 2014, the Departments of the Treasury, Labor, and Health and Human Services (the agencies) issued proposed regulations regarding the summary of benefits and coverage (SBC).

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In addition to the proposed regulations, the agencies also issued a new set of proposed SBC templates, instructions, and an updated uniform glossary. These supplementary materials are available on the Department of Labor website.

Under the Affordable Care Act, plan administrators and insurers must provide SBCs to help individuals better understand their health coverage and compare their health coverage options. These proposed regulations clarify when and how a plan must provide an SBC, streamline the SBC template, and add content to the template that is designed to help participants better understand and evaluate their coverage options.

In an effort to make the SBC more accessible and useful to participants, the size of the proposed SBC template has been reduced from eight pages to five pages. While this reduction requires the elimination of information previously included in the SBC, new information has also been added. For example, the proposed SBC template includes a mandatory statement regarding whether the plan provides minimum essential coverage and minimum value. Previously, administrators were permitted to provide this information in a separate cover letter. When these proposed regulations go into effect, the option to provide this information in a separate letter will no longer be available. The proposed rules also require the SBC to state whether abortion services are covered or excluded and whether coverage is limited to services for which federal funding is allowed. Other changes to the SBC template include the addition of a third coverage example related to cost sharing for an individual visiting an emergency room with a foot fracture.

In addition to changes in content, the proposed regulations clarify who is responsible for certain disclosure obligations. For example, the proposed rules provide that if a plan enters into a binding contract with another party to provide an SBC, the plan would be considered to satisfy its disclosure requirement so long as the plan monitors the other party and takes the required steps to address any non-compliance of which it has knowledge. The proposed rules also clarify that if a plan uses two or more insurance products provided by separate insurers, the plan administrator will be responsible for providing the complete SBC unless the administrator contractually delegates this responsibility to one of the insurers.

These proposed regulations, including the revised SBC templates, will be effective for plan years and open enrollment periods beginning on or after September 1, 2015.

CASES

Stock Drop Case Update: Plaintiffs Allegations Sufficient to Withstand Motion to Dismiss. A federal district court in the Second Circuit denied the motion to dismiss filed by defendants in a stock drop case in which plaintiffs sued plan fiduciaries for alleged Employee Retirement Income Security Act of 1974 (ERISA) violations involving the failure to prudently manage the assets of two defined contribution plans maintained by Eastman Kodak Company (Kodak). The case is noteworthy because it is one of the early stock drop case rulings published following the Supreme Court's decision in *Fifth Third Bancorp v. Dudenhoeffer* (US Sup. Ct. 2014). The Supreme Court in *Dudenhoeffer* concluded the ERISA does not create a special presumption favoring fiduciaries of plans that invest in company stock and does not require plaintiffs to allege particular circumstances such as the employer being on the "brink of collapse."

The two plans involved in the Kodak case are an employee stock ownership plan (ESOP) and a 401(k) plan. The ESOP document states that plan assets are to be invested primarily in Kodak stock, while the 401(k) plan provides for the establishment of a Kodak stock fund and offers participants the opportunity to voluntarily invest their plan accounts in that

Kodak stock fund. After 2009, the plaintiffs allege that Kodak's stock value steadily declined. In early 2012, Kodak filed for bankruptcy protection under Chapter 11. The plaintiffs in the case filed suit later in 2012, alleging that defendant fiduciaries of the two plans acted imprudently and "knew or should have known that Kodak's financial condition was poor, that its long-term prospects were not good, and that as a result, its stock price was going to continue to decline, which it in fact did."

In deciding to deny defendants' motion to dismiss, the court noted that the facts in *Dudenhoeffer* were considerably different from those in this case. In *Dudenhoeffer*, plaintiffs alleged that "the fiduciaries knew or should have known that the company's stock was overvalued." In this case, there were no allegations that Kodak stock was overvalued or that the fiduciaries ignored the warning signs regarding an imminent collapse in the value of the Kodak stock. Plaintiffs in this case essentially allege that poor performance caused the company's dire financial circumstances – that "Kodak stock was on a steady decline due to fundamental problems with the company itself," and the "defendants should have stepped in and, notwithstanding the directives in the plan documents, ceased to maintain the funds' investments in Kodak stock."

Notwithstanding the factual differences between *Dudenhoeffer* and this case, the court concludes that plaintiffs had not failed to make out a claim that fiduciaries either should have "ceased offering the ESOP as an investment option, sooner than they did, or stopped investing the plan's assets in Kodak stock." In fact, the court noted that even without the *Dudenhoeffer* decision and even if the *Moench* presumption of prudence still controlled, "the allegations in the complaint might well be sufficient to withstand a motion to dismiss," particularly given the publicly available information that documented "Kodak's inexorable slide toward bankruptcy" and accurately forecasted "Kodak's bleak future." (*Gedek v. Perez*, WDNY 2014)

Long Legal Journeys of Case Defining Meaning of Partial Termination May Have Come to a Close (Maybe This Time). Last year, we reported on a district court decision in *Matz v. Household International*. We indicated that the decision, after more than18 years of litigation, finally determined that a partial termination of a plan had not occurred. A partial termination would have resulted in vesting of benefits for certain plan participants. That prediction was a little too soon. The plaintiff appealed the district court's decision that a partial termination did not occur to the U.S. Court of Appeals for the Seventh Circuit. This was the fifth time an appeal of this case had reached the Seventh Circuit. The court seemed slightly perturbed that the class action lawsuit was continuing in what the court described as a "seemingly interminable class action suit." This opinion focused on a procedural issue involved in class action lawsuits. In deciding this case at the district court level, the class representative, Matz, lost. The Seventh Circuit pointed to a complication not dealt with by the district court; that is, the decision that Matz losses applies only to Matz individually and is not necessarily applicable to the other members of the class. The Seventh Circuit reviewed the factual findings related to all the transactions that occurred in this matter; it found that in all situations the percentage of participants that were terminated did not reach the 20 percent threshold defining a partial termination that the Seventh Circuit established in an earlier decision. Thus, since the 20 percent threshold had not been reached under any manner of calculation, the court dismissed the appeal, finding that the suit has no merit. (*Matz v. Household Int'l Tax Reduction Inv. Plan*, 7th Cir., 2014)

Employer Liable for Failing to Timely Withhold FICA Taxes on Nonqualified Deferred Compensation. A recent district court case illustrates the importance of employers properly withholding Social Security and Medicare (FICA) taxes on nonqualified deferred compensation when the benefits vest. Under the "special timing rule" of Internal Revenue Code

(Code) Section 3121(v), amounts deferred under a nonqualified deferred compensation plan are treated as wages for FICA purposes on the later of when services are performed or the date on which the right to the deferred compensation is no longer subject to a substantial risk of forfeiture – that is, when the amounts vest. The "nonduplication rule" provides that once an amount is taken into account and the FICA taxes paid, neither the deferred amount nor any earnings on that amount will again be subject to FICA tax. These timing rules can result in significant tax savings. For example, if an employee's benefit under a deferred compensation plan vests at the employee's retirement, the entire present value of that benefit is treated as wages for FICA tax purposes at that time. If the employee's wages at the time of taxation exceed the Social Security wage base ($87,000 in 2003, the year in question), all amounts over that base would be subject only to the 1.45 percent Medicare tax (for each of employer and employee). As the benefits are paid out following retirement, no further FICA taxes are due. On the other hand, if the employer fails to withhold FICA taxes at the correct time, the amounts deferred (and earnings on those amounts) are subject to FICA taxes when the benefits are paid. If the payment schedule covers a period of years, the payments are subject to both Social Security and Medicare taxes each year that payment continues.

In this case, the former employer of John Davidson, a participant in the company's deferred compensation plan, failed to withhold FICA taxes on the present value of Davidson's benefits at the time of his retirement in 2003, when the taxes were due. In 2011, the company notified Davidson and a group of other retirees that it had made a mistake by not previously withholding the taxes on their deferred compensation and that FICA taxes would be withheld on all future payments of their benefits. They were informed that the company had corrected the underpayment of FICA taxes for all open years going back to 2008 by paying both the employee and the employer share of past taxes, and that it would recoup the employee share of the repaid taxes by reducing their future benefit payments for a 12- to 18-month period.

Davidson filed suit under ERISA in 2012, arguing that his benefits were being reduced because of the company's error in failing to withhold FICA taxes on his benefits in 2003 when they were due. Class action status was granted in 2014, and Davidson was appointed the class representative in the suit. According to Davidson, had the company properly withheld FICA taxes in 2003, he would have owed no further FICA taxes on his benefit payments in subsequent years. The district court agreed and granted summary judgment to Davidson and other retirees. The court noted that Davidson was not challenging the right of the company to withhold FICA taxes from his benefit payments. Rather, he was arguing that the company should pay his share of the FICA taxes due, because the company was responsible for the original withholding error. The court agreed that the company's failure to withhold the taxes at the correct time resulted in higher taxes for the retirees, because they lost the benefit of the nonduplication rule.

The court disagreed with Davidson that the Code *mandates* that employers withhold under the special timing rule (even though the regulations state that the timing rule is not elective), but held that failure to follow the rule violated plan terms. The terms of the company's deferred compensation plan required the company to "ratably withhold from that portion of the participant's compensation that is not being deferred the participant's share of all applicable federal, state or local taxes." Thus, the company was required by the plan to "properly and timely withhold the participants' taxes while the funds were within the control" of the company. The court concluded that the company's failure to follow the express terms of the plan resulted in higher taxes and reduced benefits in violation of ERISA. (*Davidson v. Henkel Corp.*, E.D. Mich., 2014)

When Do Retiree Medical Benefits Vest? The U.S. Supreme Court Levels the Playing Field. In a unanimous decision, handed down on January 26, 2015, the U.S. Supreme Court decided that ordinary principles of contract law determine the amount and duration of collectively bargained retiree medical benefits. *M & G Polymers USA, LLC v. Tackett*. In so doing, the court rejected a longstanding rule of construction, known as the *Yard-Man* inference, established by the U.S. Court of Appeals for the Sixth Circuit and applied by the court in *Tackett* in ruling that M&G Polymers could not unilaterally modify collectively bargained retiree medical benefits following the expiration of the collective bargaining agreements at issue. In its simplest formulation, the *Yard-Man* inference means that when a union and an employer contract for benefits that accrue upon retirement, a court may infer, absent evidence to the contrary, that the parties likely intended those benefits to continue as long as the beneficiary remains a retiree. In *Tackett*, the Supreme Court unanimously held that when a contract is silent as to the duration of retiree benefits, as was the case in *Tackett*, a court may not infer that the parties intended those benefits to vest for life. The Supreme Court vacated the judgment of the Sixth Circuit and remanded the case for that court to apply ordinary principles of contract law in determining the vested status of the retiree benefits at issue in *Tackett*.

What Are the "Ordinary Principles of Contract Law"?

The concurring opinion, authored by Justice Ginsburg and joined by Justice Breyer, Justice Sotomayor, and Justice Kagan, stated the analysis quite succinctly:

> Today's decision rightly holds that courts must apply ordinary contract principles, shorn of presumptions, to determine whether retiree health-care benefits survive the expiration of a collective-bargaining agreement. Under the "cardinal principle" of contract interpretation, "the intention of the parties, to be gathered from the whole instrument, must prevail." To determine what the contracting parties intended, a court must examine the entire agreement in light of relevant industry-specific "customs, practices, usages, and terminology." When the intent of the parties is unambiguously expressed in the contract, that expression controls, and the court's inquiry should proceed no further. But when the contract is ambiguous, a court may consider extrinsic evidence to determine the intentions of the parties.

What Is Extrinsic Evidence?

Extrinsic evidence is evidence outside of the four corners of the collective bargaining agreement. This may include ERISA plan documents and SPDs, the prior practice of the parties, outside memoranda, discussions of the parties surrounding the agreement, and employee communications, both written and verbal.

Where Does This Leave Us?

Where a collective bargaining agreement *unambiguously* vests the amount and duration of retiree medical benefits upon retirement, an employer may not unilaterally reduce or terminate the benefits prior to date set forth in the agreement (e.g., prior to age 65 or death).

Where a collective bargaining agreement is *ambiguous* as to the amount and duration of retiree medical benefits, a court must apply ordinary contract principles to determine whether these benefits may be unilaterally altered or terminated by the sponsor.

The Supreme Court's decision calls into question a line of cases that stand for the proposition that in order to vest, an intent to vest retiree medical benefits must be found in the plan documents, and must be stated in clear and express language. The concurring opinion specifically rejected this rule of construction, stating that " no rule requires "clear and express" language in order to show that parties intended health-care benefits to vest."

What Should Employers Do in Light of *Tackett*?

As difficult as it may be to do, employers and unions should come to terms on the issue of vesting and ensure that the agreement of the parties, including the rights of the employer to amend or terminate, are clearly and completely documented in the collective bargaining agreement. An agreement that is silent or ambiguous on this matter will leave a subsequent disagreement to the judgment of a court.

Second Circuit Upholds Reformation Remedy in *Amara* Part II. In the long-running dispute between Cigna Corporation and participants in the company's pension plan, the U.S. Court of Appeals for the Second Circuit recently affirmed a decision by the district court that those participants are entitled to increased benefits under a theory of equitable reformation.

At the heart of the case were certain misrepresentations by the company to participants when converting its defined benefit pension plan to a cash balance plan. That the communications from the company were inaccurate was not in dispute. The district court originally ordered, under ERISA § 502(a)(1)(B), that Cigna reform the plan's terms to be consistent with the representations made to participants by providing the full benefits accrued under the defined benefit pension plan at the time of the conversion plus the benefits accrued under the cash balance plan (referred to as the "A + B benefits"). ERISA § 502(a)(1)(B) creates a cause of action in favor of a participant or beneficiary to recover benefits due to him or her under the terms of a plan, to enforce his or her rights under the terms of the plan, or to clarify his or her rights to future benefits under the terms of the plan. The Second Circuit affirmed the district court's original ruling.

The company then appealed to the Supreme Court, which held that the relief ordered by the lower courts was not available under ERISA § 502(a)(1)(B). However, the Supreme Court remanded the case with instructions that the district court should consider whether ERISA § 502(a)(3) entitles the participants to relief. ERISA § 502(a)(3) creates a cause of action in favor of participants, among others, to obtain appropriate equitable relief to address violations of ERISA.

On remand, the district court held that ERISA § 502(a)(3) authorized equitable reformation of the plan and again ordered that participants be provided with the A + B benefits. The Second Circuit affirmed the district court's ruling. In particular, in view of the finding that the company misrepresented the terms of the cash balance plan, the Second Circuit agreed that reformation was an appropriate remedy. The court further held that the fact that the inaccurate communications were provided by the company in its capacity as plan administrator did not prevent reformation, where the company served as both plan sponsor and plan administrator – in general, a plan may only be amended by its sponsor.

Following the Supreme Court's earlier decision in the *Amara* case that inaccuracies in participant communications are generally not actionable under ERISA § 502(a)(1)(B), the Second Circuit's decision stands for the proposition that ERISA § 502(a)(3) may provide relief for any inaccurate participant communications. (*Amara v. Cigna Corp.*, 2d Cir. Dec. 23, 2014)