EMPLOYEE BENEFITS DEVELOPMENTS APRIL 2015

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Special Compliance Alert

Health Insurance Company's HIPAA Breach Affects Millions. At the end of January, a national BlueCross BlueShield affiliate, Anthem, Inc., discovered that its information technology systems were hacked. The information believed to have been accessed includes names, member ID numbers, dates of birth, addresses, social security numbers, e-mail addresses, telephone numbers, and employment information, including income data. This breach not only affected group health plans directly insured or administered through Anthem, but also plans that utilized the BlueCross BlueShield "BlueCard" program. Employers notified that their participants' information was disclosed are required to take action to comply with the HIPAA breach notification requirements. These actions include notifying affected individuals, the Department of Health and Human Services, and, in some cases, local media. In certain situations, employers, especially those not subject to the Employee Retirement Income Security Act (ERISA), are also required to take action to comply with state privacy laws. Failure to comply with these notice requirements in a timely manner could subject an employer to significant penalties. In addition to complying with the notice requirements, employers should also review and update their HIPAA compliance documents (e.g., HIPAA privacy & security policies, business associate agreements, HIPAA notice of privacy practices, training log, etc.).

Agency Guidance

Temporary Nondiscrimination Relief Extended for "Closed" Pension Plans. In recent years, many employers who are sponsors of defined benefit pension plans have decided to "freeze" plan participation (i.e., close the pension plans to new entrants, but allow ongoing accruals for some or all of the employees who participated in the plan on a specified date), and to instead provide retirement benefits to their newly hired employees using a defined contribution plan. In the early years following the participation "freeze," the closed pension plan may be able to continue satisfying the applicable minimum coverage requirements. However, the minimum coverage requirements, in time, typically become more difficult for a closed pension plan to

satisfy - the proportion of plan participants who are highly compensated employees (HCEs) frequently increases (for example, because non-highly compensated employees (NHCEs) tend to have higher rates of turnover than HCEs). If the closed pension plan cannot satisfy the minimum coverage requirement on its own, it may need to be aggregated with another plan so it can satisfy the coverage requirement. And if an employer's closed pension plan is aggregated for coverage compliance purposes with a defined contribution plan that covers the employer's new hires, then the closed pension plan also must be aggregated with that defined contribution plan for purposes of satisfying the nondiscrimination requirements of Code Section 401(a)(4). In the typical case, the aggregated plans could be expected to fail the 401(a)(4) nondiscrimination requirements unless they are permitted to demonstrate compliance with the nondiscrimination requirements on the basis of equivalent benefits.

In Notice 2014-5, the IRS provided temporary nondiscrimination relief for plan years beginning *before 2016* by permitting certain employers that sponsor both a defined benefit pension plan closed before December 13, 2013 and a defined contribution plan to demonstrate the aggregated plans comply with the nondiscrimination requirements of Code Section 401(a)(4) on the basis of equivalent benefits, even if the aggregated plans do *not* satisfy the current conditions for testing on that basis.

Recently published Notice 2015-28 now extends the temporary nondiscrimination relief provided in Notice 2014-5 for an additional year by applying that relief to plan years beginning *before 2017* if the conditions of Notice 2014-5 are satisfied. During the period for which this extension applies, the remaining provisions of the nondiscrimination regulations under Code Section 401(a)(4) continue to apply. The extension described in Notice 2015-28 is provided in anticipation of the issuance of proposed amendments to the Code Section 401(a)(4) regulations that would be finalized and apply after the relief under Notice 2014-5 and Notice 2015-28 expires.

Final 162(m) Regulations Clarify Deductibility of Performance-Based Compensation. The Internal Revenue Service (IRS) recently issued final regulations under Internal Revenue Code (IRC) Section 162(m) that generally adopt the 2011 proposed regulations on performance-based compensation, with only minor changes and clarifications. The final regulations:

1. Confirm that equity-based compensation plans must specify the maximum number of stock options and stock appreciation rights (SARs) that can be granted to an individual employee during a specified period, and
2. Clarify the specific types of compensation available for special relief during a transition period after a company becomes publicly traded.

IRC Section 162(m) limits the annual tax deduction that a public company may take for executive compensation to $1 million for each covered employee. There is an exception to the limit for performance-based compensation and for certain compensation paid by a newly public company.

To qualify for the performance-based exception, a plan must specify the maximum number of awards that may be issued to an employee during a designated time period. The 2011 proposed regulations had stated that a plan providing for options or SARs must state "the maximum number of shares with respect to which options or rights may be granted during a specified period to any individual employee." The final regulations clarify that the per-employee limitation requirement is satisfied if a plan specifies the maximum number of shares with respect to which *any type* of equity-based compensation may be granted

to an individual employee, thus explicitly including all types of equity-based awards, not merely options and SARs. Because this clarification is not considered a substantive change, the requirement applies to grants made on or after June 24, 2011.

The final regulations also contain an amendment to the transition relief available for newly public companies. During a transition period after a company becomes publicly traded, the IRC Section 162(m) limitation on deductibility does not apply to any compensation received on exercise of a stock option or SAR, or on vesting of restricted property, granted under a plan or agreement that existed before the company became publicly traded. The final regulations amend the proposed regulations to clarify that restricted stock units (RSUs) and phantom stock granted on or after April 1, 2015, will be exempt from IRC Section 162(m) only if they are paid and settled (not just granted) before the transition period expires, and that RSUs and phantom stock granted during a transition period before this effective date will continue to be exempt, even they are paid and settled after the transition period expires. T.D. 9716, http://www.irs.gov/irb/2015-15_IRB/ar09.html

IRS Issues Guidance Updating Employee Plans Compliance Resolution System. The IRS maintains the Employee Plans Compliance Resolution System (EPCRS), a comprehensive correction program designed to allow sponsors of tax-favored retirement plans to correct qualification failures and thereby maintain the plan's tax-favored status. In the form of two revenue procedures, the IRS released guidance updating EPCRS.

Correction of Overpayment Failures

One common qualification failure that occurs is that a participant or beneficiary receives an overpayment from a plan. An overpayment can occur because a participant receives amounts in excess of what he or she is entitled to under the Internal Revenue Code (Code) or the plan, or the participant receives benefits at a time when he or she is not permitted to receive benefits under the plan.

EPCRS previously provided that a plan sponsor must take reasonable steps to have an overpayment (with an appropriate interest or earnings adjustment) returned to the plan by the recipient as part of any correction of an overpayment failure.

The IRS's guidance provides that, depending on the facts and circumstances, an appropriate correction for an overpayment may be for the plan sponsor to contribute the overpayment amount (adjusted for earnings or interest) to the plan, rather than the recipient. Another potential correction may involve a retroactive plan amendment to conform the plan document to the plan's operations.

The guidance requests comments on the issue of overpayments and states that the IRS intends to make further revisions to EPCRS regarding the correction of overpayments.

Elective Deferral Failures

In general, when an employer improperly excludes an employee from making elective deferrals under a 401(k) plan, the correction under EPCRS is for the employer to make a contribution to the plan on behalf of the affected employee equal to 50 percent of the missed deferral. Commentators to the IRS complained that the cost associated with making corrective contributions for failures to correctly implement automatic contribution features was a deterrent to including those features in a plan, when those features are simultaneously viewed as a means of encouraging greater participation by employees. Commentators also complained that the 50 percent make-up contribution, which is designed to reflect the lost tax deferral that results when an employee receives the missed deferral as wages instead of having the amount deferred into the plan,

created a windfall for employees in many circumstances.

The IRS's update to EPCRS adds a safe harbor correction method for elective deferral failures associated with an automatic contribution feature. An automatic contribution feature includes both automatic enrollment and automatic escalation features. If the safe harbor correction method is complied with, no make-up contribution for elective deferrals is required to be made by the employer. Under the safe harbor, certain notice requirements must be met and correct deferrals must begin no later than the earlier of:

1. The first pay date on or after the end of the 9½ month period after the end of the plan year of the failure, or
2. The first pay date on or after the last day of the month after the month the employer is notified by the employee of the failure.

Even if no corrective contribution is required for missed elective deferrals, a corrective matching contribution (adjusted for earnings) may still be required. The safe harbor correction method for automatic contribution feature failures applies only to failures that begin on or before December 31, 2020, though the IRS may later extend this safe harbor for failures that begin in later periods.

The IRS guidance also modifies the EPCRS correction rules to provide a safe harbor for any elective deferral failure that is of short duration. No corrective contribution is required for the missed elective deferrals if certain notice requirements are met and correct deferrals begin no later than the earlier of:

1. The first pay date on or after the last day of the three-month period that begins when the failure first occurred, or
2. The first pay date on or after the last day of the month after the month the employer is notified of the failure by the employee.

However, a matching contribution (adjusted for earnings) may still be required.

Finally, if the safe harbors previously described do not apply, an employer may correct an elective deferral failure by making a reduced corrective contribution of 25 percent of the missed deferral if correct deferrals begin no later than the earlier of:

1. The first pay date on or after the last day of the second plan year following the plan year in which the failure occurred, or
2. The first pay date on or after the last day of the month after the month the employer is notified by the employee of the failure. Again, certain notice requirements must be met and a matching contribution (adjusted for earnings) may be required.

<u>Change in VCP Fees</u>

One component of EPCRS is the Voluntary Compliance Program (VCP). As part of a VCP submission to the IRS, an employer must pay a VCP compliance fee.

Previously, the VCP fee for minimum required distribution failures under Code Section 401(a)(9) was $500 for submissions involving 50 or fewer participants. If a submission involved more than 50 participants, the general VCP fee schedule would apply. The VCP fee under the general schedule is based on the number of plan participants.

Under the IRS guidance, the VCP fee for minimum required distribution failures is as follows:

Number of Participants Affected by Failure	**VCP Fee**
150 or fewer	$500
151-300	$1,500
More than 300	General VCP Fee

In general, the VCP fee for a participant loan failure under Code Section 72(p) was previously 50 percent of the general VCP fee. The updated IRS guidance modifies the VCP fee for a participant loan failure in accordance with the following table:

Number of Participants With Loan Failures	**VCP Fee**
13 or fewer	$300
14-50	$600
51-100	

$1,000

101-150

$2,000

Over 150

$3,000

Deleting Use of Social Security Letter Forwarding Program

When additional benefits are due a participant, but the participant cannot be located, a plan sponsor must take reasonable actions to locate the participant. One step plan sponsors could take after initial efforts to locate a participant were unsuccessful was to use the Social Security letter forwarding program. However, in view of the Social Security Administration's announcement that the letter forwarding program has been discontinued as a method for locating lost retirement plan participants, EPCRS has been updated to delete any reference to the program as a means of searching for a lost participant.

When Determination Letter Application Is Required

The update to EPCRS clarifies the circumstances in which a determination letter application is required to be submitted as part of a qualification failure that will be corrected by a retroactive plan amendment.

Previously, a determination letter was not required and could not be submitted with a VCP submission involving a plan amendment if:

1. The amendment was an IRS model amendment,
2. The amendment involved the adoption of a pre-approved plan with an IRS opinion or advisory letter on which the plan sponsor may rely, or
3. The failure being corrected was a demographic failure (e.g., a failure to satisfy minimum coverage under Code Section 410(b)).

The update to EPCRS provides two additional circumstances in which a determination letter is not required in connection with a VCP submission that involves a qualification failure that will be corrected by plan amendment:

1. The adoption of an amendment to a previously adopted pre-approved plan with an IRS opinion or advisory letter on which the plan sponsor may rely, and
2. More than 12 months have elapsed since the date that substantially all of the plan's assets were distributed in connection with the plan's termination.

The guidance also clarifies that, in the case of an individually designed plan, a determination letter will be required to be submitted in connection with a VCP submission that involves a qualification failure being corrected by a plan amendment if either:

1. The qualification failure is an operational failure and is being submitted during the last 12 months of the plan's remedial amendment cycle or in connection with the plan's termination, or
2. The qualification failure involves a non-amender failure.

Cases

Mitigating Litigation and Liability Risks: Document and Communicate. The resolution of ERISA benefit claim disputes often depends, in large part (and sometimes exclusively), on the content of the governing plan documents. In addition to the content requirements mandated by ERISA, plan sponsors are well advised to ensure that their ERISA documents incorporate plan provisions that are designed to reduce litigation and liability risks. These provisions include plan terms that are designed to ensure:

- That aggrieved claimants cannot bypass the plan's internal claims dispute resolution process (i.e., that claimants must use this procedure before filing suit);
- That internal claims decisions will be subject to deferential review if challenged in court (i.e., so-called *Firestone* language);
- That a claimant's right to file suit following an adverse benefit decision will be forever lost unless suit is filed within a specific period of time (e.g., one year) following a specified date (e.g., the date a claim is first submitted, or the date of a final adverse claims decision);
- That medical plan providers do not have standing to sue employers or plans for benefits allegedly due under the terms of a plan (i.e., language prohibiting a claimant from assigning his or her benefit rights to a provider); and
- That litigious claimants can only file suit in a jurisdiction of the plan sponsor's choosing.

As one recent case illustrates, a failure to adequately communicate these kinds of plan provisions can render them useless. The dispute in *Spence v. Union Security Insurance Company* involved a denial of a claimant's application for long term disability benefits under a group long term disability insurance plan. Under the terms of the governing plan document at issue, aggrieved claimants were required to file suit within three years of a date specified in the document. Arguably, the plaintiff in that case did not file suit within the three-year period, and the defendant moved to dismiss the complaint. The court held in favor of the claimant, ruling that his suit was timely because the final adverse benefit determination letter did not inform him of his right to file a civil action, as required by the ERISA claims regulation.

To ensure, to the extent possible, that a statute of limitations provision in a plan document will be upheld, a plan sponsor should be sure that the provision is clearly and prominently disclosed in the summary plan description and communicated as part of an adverse claims determination. As evidenced by the ruling in *Spence*, a failure to do so could have the effect of

extending (or "tolling") a statute of limitations that otherwise would function as a bar to litigation. *Spence v. Union Security Insurance Company* (D. Ore., 2015)

District Court Finds "Float" Income Is Not a Plan Asset. A Massachusetts district court recently dismissed a group of lawsuits that accused several Fidelity entities (Fidelity) of violating ERISA by retaining "float" income on retirement plan disbursements when funds were held overnight in accounts, pending delivery to plan beneficiaries. The plaintiffs, whose lawsuits were consolidated into one action, claimed that the float income qualified as a plan asset under ERISA. They argued that Fidelity violated ERISA through its practice of using float earned on plan assets to pay banking fees that Fidelity was required to pay and through its practice of misappropriating the float income for the use of clients other than the plan participants. Drawing upon several recent decisions by the U.S. Court of Appeals for the First and Eighth Circuits dealing with float income and interest on retained asset accounts, the district court disagreed, holding that the float income retained by Fidelity did not qualify as a plan asset under ERISA. Agreeing with Fidelity that the plaintiffs' argument appeared to ignore the fact that the assets at issue were withdrawn from the plans, the court noted that the plans could have contracted for a different agreement – one under which the plans "would own the bank accounts and consequently, pay the fees, bearing the risk of loss if the account fees exceeded the interest earned." But they did not. Nor did the plaintiffs contract for an alternative arrangement under which beneficiaries would be paid from accounts owned by the plans. Because no such alternative arrangements were made, and because the float income was not a plan asset, the court found that there was no fiduciary breach and that Fidelity retained all rights to the float income. *In re Fidelity ERISA Float Litig*. (D. Mass. 2015)