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# Benefits Planning for 2004

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With so much rapid change in the world of compensation and benefits, it's hard for executives and human resources professionals to know where to focus their efforts. This article briefly highlights some issues that will deserve particular attention this year.

## HEALTH PLANS

HIPAA Privacy Compliance for Small Health Plans. Although some health plans were required to comply with the privacy rules of the Health Insurance Portability and Accountability Act ("HIPAA") by April 14, 2003, the compliance date for small health plans is April 14, 2004. A small health plan is a health plan with annual receipts of no more than $5 million, based on premiums paid by insured plans, and on total claims paid by self-insured plans, during the last full fiscal year. Covered health plans may include medical, dental, vision and prescription drug plans, health flexible spending accounts, medical reimbursement accounts and long-term care plans.

If they have not already done so, employers that sponsor small health plans should take steps immediately to ensure compliance with HIPAA by April 14, 2004. For a self-funded plan, appropriate steps will include distributing privacy notices, amending plan documents, appointing a privacy officer, identifying protected health information ("PHI"), establishing procedures regarding the handling of PHI, and entering into business associate agreements with appropriate outside vendors.

Health Savings Accounts – A New Option for Employees. On December 8, 2003, President Bush signed the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the "Act") into law. Although the primary focus of the Act was providing prescription drug benefits to seniors, the Act also allows eligible individuals to establish Health Savings Accounts ("HSAs") beginning in 2004.

An HSA is a tax-exempt vehicle that a person may use to pay qualified medical expenses. A person may establish an HSA if he or she:

- is covered under a "high deductible health plan" ("HDHP") (generally, a health plan that, for self-only coverage, has an annual deductible of at least $1,000 and requires payment of annual out-of-pocket expenses not exceeding $5,000, or for family coverage, has a deductible of at least $2,000 and requires payment of annual out-of-pocket expenses not exceeding $10,000);
- is not also covered by any other health plan that is not an HDHP;
- is not entitled to benefits under Medicare; and
- may not be claimed as a dependent on another person's tax return.

Contributions to an HSA are deductible, subject to annual limits of $2,600 for individuals with self-only coverage and $5,150 for individuals with family coverage. The limits are higher for individuals between the ages of 55 and 65. Distributions from an HSA that are used to pay qualified medical expenses are excludible from gross income.

Employers, especially those that sponsor health plans with significant deductibles, may wish to redesign their health plans to meet the definition of HDHPs under the Act, thus enabling their employees to establish HSAs. In addition, employers with HDHPs may wish to amend their cafeteria plans (or adopt new cafeteria plans) to allow employees to contribute to an HSA on a salary-reduction basis. HSAs are not subject to COBRA continuation requirements, and amounts contributed to an HSA may be carried over from year to year, making HSAs an attractive benefits option for both employers and employees. However, an employee who is covered under an HDHP may not establish an HSA if he or she is covered under another health plan that is not an HDHP (with certain limited exceptions). Employers that adopt an HDHP and encourage their employees to establish HSAs should therefore review their other benefit programs to ensure that they do not cause their employees to be ineligible.

Strengthening Plan Reimbursement Language. Most self-insured health plans have provisions allowing the plan to be reimbursed for payments made to a plan member out of recoveries that the member receives from third parties. In recent years, courts have increasingly ruled that although such provisions are enforceable, the ability of plans to fully recover their benefit payments is limited where the plan's language does not clearly spell out the plan's reimbursement rights. Plan sponsors should carefully review their plans to ensure that they can fully pursue their reimbursement rights in light of these recent court decisions.

Final COBRA Regulations? In 2003, the Department of Labor issued proposed regulations regarding COBRA continuation coverage. The regulations will likely be finalized later this year. Employers and group health plan administrators will need to review their COBRA procedures and notices to ensure that they comply with the new rules.

The proposed regulations included two new model COBRA notices – an initial COBRA notice and a COBRA election notice. Although employers are not required to use the new model notices verbatim, use of the model notices will be considered good faith compliance with COBRA's initial notice and election notice requirements until the regulations are finalized. Moreover, the preamble to the proposed regulations states that the DOL will no longer consider the use of its prior model initial COBRA notice to be good faith compliance with COBRA's initial notice requirements. Therefore, even before the final regulations are issued, employers should at least review their initial COBRA notices to make sure that they are no longer using the DOL's prior model notice.

## QUALIFIED RETIREMENT PLANS

Responding to the Mutual Fund Scandal. In recent months, the mutual fund industry has been rocked as several high-profile funds have been accused of inappropriate or outright illegal activity. Most of the allegations relate to practices known as late trading or market timing. "Late trading" occurs when the managers of a mutual fund allow an investor to place orders to sell or buy shares of the funds after 4:00 p.m. (Eastern), which is the time that mutual fund prices are established for the day, but to receive the 4:00 p.m. price. Late trading thus enables the investor to profit from information that becomes publicly known after the pricing deadline, and is therefore illegal. "Market timing" occurs when the managers of the fund allow an investor to rapidly move in and out of mutual fund shares. In doing so, the investor attempts to take advantage of inefficiencies in how mutual funds are priced. A market timer usually buys (or sells) mutual fund shares on one day because he or she believes that the fund's price has become stale, and then sells (or buys) shares of the same fund the next day. Market timing is often inconsistent with the stated long-term investment strategy of most funds, and many funds actively discourage or prohibit market timing. Nevertheless, some funds have permitted favored customers to engage in market timing.

Retirement plan fiduciaries have a duty to monitor the investment of plan assets, including the funds made available for participant-directed investments. High-ranking Department of Labor officials have stated that although fiduciaries should not panic and abandon plan investment options in a knee-jerk reaction to the mutual fund scandal, they should investigate whether their plans' funds have engaged in late trading or market timing. If so, they should formulate an appropriate response, which may include selecting alternative investment options.

Your Plan Documents Have Been Updated – But Does Your Plan Comply in Operation? Over the past several years, employers have been required to amend their tax-qualified retirement plans in response to various pieces of legislation enacted since 1994, known collectively as "GUST" and "EGTRRA." Depending on the type of plan, the deadline for making these amendments ranged from early 2002 to February 2, 2004.

Now that plan documents have been updated, it is a good time for employers to turn their attention to the administration of their retirement plans. In order to remain tax-qualified, plans must be consistently operated in accordance with their terms and with the qualification requirements of the Internal Revenue Code. Most plans, including those administered by professional fund managers or third party administrators, have known or unknown operational errors. In some cases, the errors are isolated occurrences. In other cases, they represent a systemic problem.

Over the past several years, the IRS has developed and refined the Employee Plans Compliance Resolution System ("EPCRS"), which permits employers to correct plan administration errors. In general, employers that find and correct operational problems on their own are rewarded under EPCRS with simpler correction procedures and reduced compliance fees. In fact, most operational errors that are corrected within two years can be fixed without IRS notification or approval, and without any compliance fee at all.

We strongly encourage employers to examine the past operation of their retirement plans to obtain reasonable assurance that their plans have been administered properly. If administrative errors are uncovered by the IRS in an audit – or are proven by a plan participant in litigation – the cost of correcting the problems can increase dramatically.

Don't Forget About Summary Plan Descriptions! Although the flood of retirement plan amendments in response to GUST and EGTRRA is largely in the past, employers cannot forget about their obligation to update their summary plan descriptions ("SPDs") for all of their plans. In general, SPDs must be updated and provided to employees no later than 210 days after the end of the plan year in which plan amendments are made.

In many cases, the professional administrator hired by the employer will provide updated SPDs for the employer's retirement plans. Employers should carefully review the SPDs for accuracy, because most courts allow employees to claim benefits based on an inaccurate or ambiguous SPD, even where the SPD contradicts the plan document.

QJSA/QPSA Notices Must be Revised. Defined benefit and certain other retirement plans are required to pay retirement benefits in the form of a qualified joint and survivor annuity ("QJSA") and to pay death benefits in the form of a qualified preretirement survivor annuity ("QPSA"), unless these options are waived in favor of another form of benefit distribution. Plans must provide notices to participants of their QJSA and QPSA rights at appropriate times.

Under recently issued IRS regulations, QPSA notices provided on or after July 1, 2004, and QJSA notices provided on or after October 1, 2004, must contain a meaningful comparison of the relative value of each benefit distribution option. All QPSA and QJSA notices should be reviewed and updated in anticipation of these deadlines. In conjunction with updating these notices, employers may want to review all of their plans' administrative forms to ensure that they comply with applicable regulations and accurately reflect the benefit election options available to plan participants.

Guidance on Payment of Plan Expenses. Recent guidance from the Department of Labor and the IRS clarifies how plan administrative expenses may be allocated, including circumstances where plan expenses may be allocated to specific participants' accounts. According to the DOL, ERISA's general silence on allocations endows plan sponsors with "considerable discretion" in the design and administration of plan expense allocations. The plan documents may specify, for example, whether expenses should be allocated on a per capita basis (i.e., the same dollar amount charged to each account) or on a pro rata basis (i.e., expenses charged based on relative account sizes). If plan documents are silent, a plan sponsor may select the appropriate method of allocating plan expenses, as long the method selected is prudent.

With respect to whether particular expenses may be allocated to specific accounts, the DOL significantly modified its more restrictive guidance from 1994. For example, expenses related to processing hardship distributions, determining the qualified status of domestic relations orders, and calculating benefits payable under different distribution options may, in appropriate circumstances, be charged to the account of the participant to which the expenses relate.

In January 2004, the IRS issued guidance regarding the allocation of plan expenses to the accounts of former employees. Specifically, the IRS ruled that the sponsor of a defined contribution plan may pay reasonable plan expenses for active employees directly, while charging former employees for those expenses on a pro rata or other reasonable basis.

Employers sponsoring defined contribution plans may wish to review how they allocate plan expenses in light of these recent rulings.

## EXECUTIVE COMPENSATION

Executive Compensation Audit Initiative. The IRS announced that it has undertaken a comprehensive audit initiative aimed at the compensation arrangements of senior corporate executives and directors. The initiative will focus on nonqualified deferred compensation arrangements, stock based compensation, golden parachutes, the $1,000,000 cap on deductions for compensation paid to certain executives of public companies, corporate perks such as housing allowances and use of corporate-owned aircraft and automobiles, split dollar life insurance, family limited partnerships and asset protection plans. The IRS will be auditing corporate tax returns and the personal income tax returns of the corporations' top executives. Employers who have these types of compensation arrangements may wish to review those arrangements in light of the audit initiative.

## SEVERANCE PAYMENTS

Employment Taxes on Involuntary Severance Payments – Refund Possibility. In 2003, the Court of Federal Claims ruled that severance payments made pursuant to a reduction in force were supplemental unemployment compensation benefits, and were therefore not "wages" for purposes of Federal Insurance Contributions Act ("FICA") taxes. *See CSX Corporation v. United States* (Fed. Cl., No. 95-858T). To be exempt from FICA taxes, the separation from employment must be involuntary and indefinite; severance payments pursuant to a voluntary termination of employment, or in situations where employees are still on the payroll and subject to recall, do not qualify as supplemental unemployment compensation benefits.

Employers who recently underwent a reduction in force may have paid FICA taxes on severance to employees who were involuntary terminated. Such employers may wish to consult with tax counsel about whether they are entitled to a refund of those payments.

For more information on any of the issues discussed in this *Law Bulletin,* please contact any member of our Compensation & Benefits Section.


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