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SAME-SEX MARRIAGES: POTENTIAL EFFECTS ON EMPLOYEE BENEFIT PLANS

In its November 2003 decision of *Goodridge v. Department of Public Health*, 440 Mass. 309 (2003), the Supreme Judicial Court of Massachusetts concluded that the Massachusetts Constitution prevents the Commonwealth from limiting the "protections, benefits and obligations of civil marriage to opposite sex couples." Accordingly, the court legalized same-sex marriages in Massachusetts. Massachusetts began issuing marriage licenses to same-sex couples on May 16, 2004. This development raises a number of important employee benefit issues for employers based in, or with operations in, Massachusetts. Similar issues may be raised as well for employers with employees who entered into same-sex marriages in certain New York municipalities, San Francisco, California and Portland, Oregon.

POTENTIAL EMPLOYEE BENEFIT ISSUES

Employers are faced with a myriad of issues with respect to the benefit entitlements of the purported same-sex spouses of employees. For example:

■ *Is an employee who has entered into a Massachusetts same-sex marriage "legally married"?*

Same-sex couples who reside in Massachusetts and intend to continue to reside in Massachusetts can be legally married in the Commonwealth of Massachusetts, unless the Massachusetts Constitution is amended to bar same-sex marriages. Massachusetts Governor Romney and Attorney General Reilly ordered towns and cities not to issue marriage licenses to nonresident same-sex couples. This order was based on a 1913 state law prohibiting marriage between residents of another state if their marriage would be "void" in their home state. Initially, a number of municipalities issued licenses to nonresident same-sex couples. However, these municipalities have temporarily suspended the issuance of marriage licenses to out-of-state same-sex couples. The legal validity of the marriages of same-sex couples who did not reside in Massachusetts is not known at this time.

■ *What about same-sex marriages entered into elsewhere?*

The legal status of same-sex marriages in states other than Massachusetts continues to be the subject of controversy and litigation. For example, on August 4, 2004, a King County Superior Court Judge in the State of Washington ruled that Washington's Defense of Marriage Act, which was enacted in 1998, violates the state constitution. This court decision is stayed until the Washington Supreme Court reviews the case, but, depending on the outcome of this case, same-sex marriages may become lawful in Washington State. The Attorney General of the State of New York has announced his opinion that same-sex marriages entered into in New York are not valid under applicable New York statutes, although he also indicated that New York would likely recognize as valid same-sex marriages entered into in other states or countries (such as Canada) that permit such marriages. Most recently, on August 12, 2004, the California Supreme Court ruled that the same-sex marriages performed in San Francisco in February and March 2004 are void, on the ground that the mayor of San Francisco was not authorized by state law to approve the issuance of licenses for such marriages. However, the court reserved for another day the question of whether the California state statute limiting marriage to opposite-sex couples violates the California state constitution; such a challenge is currently working its way though the lower courts. In short, as of the date of this article, Massachusetts remains the only state where same-sex marriages can be lawfully performed, but other states may soon begin permitting such marriages as well.

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SAME-SEX MARRIAGES: *POTENTIAL EFFECTS ON EMPLOYEE BENEFIT PLANS*

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■ *What is the legal status of the same-sex marriage of a Massachusetts resident who moves to another state?*

Generally, the "full faith and credit" clause of the United States Constitution requires every state to recognize legally valid marriages entered into in other states. The federal Defense of Marriage Act of 1996 (DOMA), however, provides that no state is required to recognize same-sex marriages that were legally performed in another state. Most states have enacted statutes expressly providing that same-sex marriages entered into in other jurisdictions will not be recognized as valid if the individuals move to those states. Other states without such statutes may choose to recognize such marriages as valid. As noted, New York, for example, appears willing to do so.

■ *Would the spouse of an employee in a legal same-sex marriage be eligible for spousal benefits under the company's benefit plans?*

The issue of whether an employee's same-sex spouse is eligible for spousal benefits under the employer's benefit plans depends primarily on the terms of the applicable plans. For example, it is possible that the same-sex spouse of an employee married in Massachusetts could claim entitlement to benefits in a medical plan that either (i) simply provides for coverage or benefits for an employee's "spouse" without defining that term; or (ii) defines spouse as "legal spouse" or "the person to whom the employee is lawfully married."

Employers should review the definition of "spouse" in each employee benefit plan. It is possible that "spouse" is defined differently in each benefit plan. Further, employers may be interested in maintaining, clarifying, or changing the existing definition of spouse in each benefit plan.

An employer may decide to exclude a same-sex spouse from the definition of spouse in an employee benefit plan. Alternatively, the employer may wish to recognize the same-sex spouse as the employee's lawful spouse for benefits purposes, particularly where the employee is located in Massachusetts or in a state that recognizes a Massachusetts same-sex marriage as valid.

The decision to include or exclude a same-sex spouse from the definition of spouse for each employee benefit should take into account numerous factors, such as the following:

1. **Medical Benefits Funded Through Insurance.** If an employer adopts a policy of allowing employees to enroll same-sex spouses in the employer's medical plan, then the employer should confirm with the insurance company that such coverage is available.
2. **Tax Consequences of Medical Benefits to Same-Sex Spouses.** As discussed below, the medical benefits provided to an employee's same-sex spouse may result in federal and state taxable income to the employee. The employer may have federal and state tax-reporting and - withholding obligations with respect to the medical benefits provided to employees' same-sex spouses.
3. **COBRA Continuation of Medical Benefits to Same-Sex Spouses.** As discussed below, in the case of medical benefits, the employer should consider whether it wishes to, or perhaps may be required to, offer COBRA continuation coverage to a same-sex spouse.
4. **Tax-Qualified Status of Retirement Plans.** As discussed below, treating same-sex spouses as "spouses" under a tax-qualified plan may create qualification issues for the plan.
5. **Applicability of ERISA.** Medical, life, disability and other "welfare" plans, as well as retirement plans, are subject to ERISA, unless such plans are church plans or governmental plans. ERISA does not apply to other types of employee benefits, such as bereavement policies, employee discount arrangements, and other similar fringe benefits or "payroll practices." Employers that do not recognize valid same-sex marriages for purposes of non-ERISA-covered plans and programs should anticipate that they may be challenged under state laws prohibiting discrimination on the basis of sexual orientation.

■ *What are the federal and state income tax consequences to the employee of enrolling the employee's same-sex spouse in the employer's medical plan?*

Under DOMA, same-sex marriages are not recognized as valid for purposes of any federal statute, including ERISA and the Internal Revenue Code, even if they are valid under one or more state laws. Therefore, for federal income tax purposes, same-sex spouses will be treated the same as domestic partners who are provided benefits — that is, the benefits will be taxable to the employee unless the same-sex partner qualifies as a "dependent." Treatment under state tax law will likely turn on whether the state recognizes the marriage as lawful. On July 7, 2004, the Commonwealth of Massachusetts Department of Revenue issued Technical Information Release 04-17 which explains the Massachusetts tax implications of the *Goodridge* decision. This technical information release provides, in part, that the "value of spousal benefits that are tax-exempt for opposite-sex spouses under federal law are also tax-exempt for same-sex spouses under Massachusetts law, and are not subject to withholding for state income tax purposes."

■ *Is the employer's medical plan required to offer COBRA coverage to the employee's same-sex spouse?*

Under federal COBRA, continuation coverage would not need to be extended to a same-sex spouse. However, depending on the legal status of the marriage in the employee's home state, that state's "baby COBRA" statute (if it has one) might require that continuation coverage be provided, unless that statute is preempted by ERISA, as would likely be the case for a self-insured medical plan (other than one sponsored by an ERISA-exempt employer, such as a governmental entity or a church-related employer). An employer, however, may decide to extend COBRA coverage to same-sex spouses, subject to the terms of the relevant insurance

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Self-Correcting Delinquent Contributions

In response to employee concerns, the DOL has recently stepped up the enforcement of its regulations concerning deadlines for sponsors of 401(k) plans to deposit employee contributions. To encourage plan sponsors to come clean on their own, the DOL has also developed a self-correction program for delinquent employers.

The Deposit Deadline

DOL regulations require a 401(k) plan sponsor to deposit participant contributions at the earliest date the funds may reasonably be segregated from the sponsor's general assets, but no later than the 15th business day of the month following the month such amounts were withheld. Because the vast majority of payroll is processed electronically, the DOL generally expects deferrals to be "reasonably segregated" well before the regulation's outer limit.

Failure to timely deposit employee contributions results in a prohibited loan from the plan to the employer, which is subject to an excise tax equal to 15% of the interest deemed to accrue during the period the contributions should have been deposited. The DOL may also assess civil penalties against a plan sponsor of up to 20% of the late deposits plus earnings.

Formal Corrective Measures: VFC Program

A delinquent employer can take advantage of the DOL's Voluntary Fiduciary Correction (VFC) Program to resolve its problems. In order to do so, it must follow the four steps outlined in the notice at the DOL's Internet homepage:

- Identify the violation as a "Delinquent Participant Contribution to Pension Plans," which is one of the 15 violations covered under the VFC Program;
- Follow the process for correcting the delinquent contributions listed in the notice;
- Calculate and restore any losses and profits with interest and distribute any supplemental benefits to participants; and
- File an application with the appropriate DOL Employee Benefits Security Administration (EBSA) regional office that includes documentation showing evidence of the corrected financial transactions.

Plan sponsors using the program must fully and accurately correct violations. Incomplete or unacceptable applications may be rejected, thereby subjecting the employer to a DOL enforcement action and/or the assessment of civil monetary penalties.

The VFC Program provides rules for making acceptable corrections for delinquent deposits. Generally, plan sponsors must restore the plan, participants and beneficiaries to the condition they would have been in had the breach not occurred. Consequently, plan sponsors correcting for delinquent deposits of participant contributions must restore to the plan the principal amount involved, plus the greater of (i) lost earnings starting on the date of the loss and extending to the recovery date, or (ii) profits resulting from the use of the principal amount for the same period. Likewise, plan sponsors must pay the expenses associated with correcting the violation.

Pros and Cons of VFC Program

Plan sponsors that successfully use the formal VFC Program will receive a no-action letter from the DOL that provides applicants relief from:

- Potential DOL civil investigations;
- Potential DOL civil action;
- The 20% civil penalty under ERISA Section 502(l); and
- The imposition by the IRS of a 15% excise tax for conducting a prohibited transaction.

The DOL implemented excise tax relief to encourage use of the program by plan sponsors that are delinquent in depositing participant contributions. However, to qualify for the excise tax exemption, plan sponsors must (i) not have applied for relief from any violation for a similar transaction under the VFC Program within the past three years, (ii) repay delinquent contributions no more than 180 days from the date they were originally required to deposit the contributions, and (iii) provide notice of the violation and the correction to participants and other interested parties.

The disadvantages of using the VFC Program include the administrative burden and cost (including legal fees) of preparing the filing, the DOL filing fee (ranging from $1,000 for plans with fewer than 50 participants, to $25,000 for plans with more than 10,000 participants) and the fact that EBSA reserves the right to investigate the correction. Moreover, to get the full benefit of the VFC Program, particularly the excise tax exemption, the plan sponsor must provide notice to interested parties. Such notice to participants and interested parties of the violation may have an adverse effect on employee relations.

Informal Corrective Measures

A plan sponsor can also obtain relief from potential penalties by informally self-correcting the delinquent contributions through the correction methods described under the VFC Program without filing an application with the DOL. A plan sponsor utilizing the informal procedure will remain liable to the IRS for the 15% excise tax penalty; however, a sponsor properly correcting the violation will avoid the assessment of the 20% civil penalty by the DOL and the requirement of notifying interested parties of the violation.

Pros and Cons of Informal Self-Correction

Rather than use the VFC Program, a plan sponsor may choose to correct the violation informally when the plan sponsor cannot meet the requirements of the excise tax exemption. Likewise, a plan sponsor may choose to informally correct the violation when the potential excise tax penalty is less than the VFC Program's filing fee.

The disadvantage of proceeding informally rather than formally is that a plan sponsor cannot obtain the excise tax exemption or the certainty that the VFC Program provides against future DOL action. If the DOL discovers the violation on a subsequent audit, and determines that the correction was not complete, the DOL may assess a 20% civil penalty on any additional amounts required to fully correct the violation.

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WHAT EVERY BENEFITS PROFESSIONAL NEEDS TO KNOW ABOUT THE FINAL COBRA NOTICE REGULATIONS

The DOL recently issued final regulations under COBRA that will require most health plan sponsors to update their COBRA forms and notices this year. The new rules are very similar to the DOL's proposed regulations issued in May 2003 and apply to notice obligations that arise on or after the first day of the plan year starting on or after November 26, 2004 January 1, 2005 for calendar-year plans. As described in this article, these regulations will impose new obligations on plan sponsors and will likely require them to update their COBRA administrative procedures.

COBRA requires group health plans to provide participants and beneficiaries, who under qualifying circumstances would lose coverage, the opportunity to elect to continue coverage under the plans at group rates for a limited period of time. The new COBRA rules set forth the minimum standards for the content and timing of the notices mandated by COBRA and establish requirements for administering the notice process. The final regulations contain model general and election notices that can be used by single-employer plans. However, the DOL has not issued model forms of all required COBRA disclosures.

The Required Notices. The regulations describe various types of notices that are currently mandated by COBRA: the general notice, the employer's notice to the administrator of a qualifying event, the employee's or qualified beneficiary's notice to the employer of certain qualifying events, and the plan administrator's notice. In addition, the regulations mandate the use of two documents that were described in the proposed regulations but have not previously been required: the unavailability notice and the early termination notice.

General or Initial Notice of COBRA Rights. Group health plans must furnish a written notice to each covered employee and his or her spouse upon commencement of the employee's plan participation. This notice must be provided by the earlier of (1) 90 days from the date of initial coverage, or (2) the date on which the employer is required to furnish an election notice (described below). The regulations permit the sponsor to combine the initial COBRA notice with the summary plan description (SPD) for the plan. Providing the initial notice in the SPD by delivery at the workplace will not satisfy the notice requirement with respect to the spouse.

The DOL has provided a model initial notice that updates the model provided in prior regulations. The form has been simplified to allow placement of plan-specific information at the end of the notice. This model differs from the one contained in the DOL's 2003 proposed COBRA regulations by eliminating (a) references to COBRA beginning dates, and (b) the requirement that the notice describe how qualified beneficiaries are to notify the plan of a second qualifying event. While use of the model is not mandatory, the model is deemed to comply with COBRA's requirements.

Employer's Notice to Plan Administrator of Qualifying Event. If the qualifying event triggering entitlement to COBRA is (a) the employee's termination of employment, (b) reduction in the employee's hours, (c) the employee's death, (d) the employee's entitlement to Medicare, or (e) with respect to a retired employee, the employer's commencement of a bankruptcy proceeding, the employer is required to provide notice to the plan administrator of the qualifying event. The employer must provide this notice (1) within 30 days of the date the employee or qualified beneficiary loses coverage under the plan due to a qualifying event (for plans that use the loss of coverage as the triggering event for COBRA continuation coverage), or (2) 30 days from the date the qualifying event occurred (for all other nonmultiemployer plans). This notice must provide sufficient information to enable the administrator to determine the plan, the covered employee, the qualifying event and the date of the qualifying event. The regulations do not include a model notice to the plan administrator.

Qualified Beneficiary's Notice to Plan Administrator of Qualifying Event: Each covered employee or qualified beneficiary is required to provide notice to the plan administrator of the following qualifying events: (a) divorce, (b) legal separation, or (c) a child's becoming no longer eligible for plan coverage. In addition, an employee or qualified beneficiary is required to notify the plan administrator of his or her disability or other second qualifying event.

The plan must allow the employee or qualified beneficiary at least 60 days to provide notice of a divorce, legal separation, child's ceasing to be a dependent under the plan, or a second qualifying event. This 60-day period runs from the latest of (a) the date of the qualifying event, (b) the date on which coverage is lost, or (c) the date on which the qualified beneficiary is informed, through a general notice or SPD, of the procedures to provide such notice. The qualified beneficiary must notify the plan administrator of his or her disability within 60 days of the latest of (1) the date of the Social Security Administration's disability determination, (2) the date on which the qualifying event occurs, (3) the date on which the qualified beneficiary loses coverage, or (4) the date on which the qualified beneficiary is informed of the obligation to provide the notice.

The regulations permit the plan to establish reasonable procedures that covered employees and qualified beneficiaries must use to furnish these notices. The plan's procedures will generally be considered reasonable if they are described in the SPD and specify who in the organization is to receive the notice, the means that qualified beneficiaries must use to effect the notice, and the required contents of the notice. It is important for the plan to have these procedures in place because, without them, notice will be deemed to have been provided when written or oral communication identifying a specific event is communicated in a manner reasonably calculated to deliver the message to the party or parties that customarily have been considered responsible for the plan. For example, if the plan does not communicate its notice procedures to participants, then a casual conversation with a human resources representative could be deemed to be valid notice of a COBRA qualifying event.

Plan Administrator's Notice to Qualified Beneficiary of Qualifying Event

Election Notice. The plan administrator must provide notice of the right to elect continuation coverage to the qualified beneficiary within 14 days of being notified of the qualifying event. Where the employer is

the plan administrator, the employer must provide notice within 44 days after the date of the qualifying event, or for plans that provide that COBRA continuation begins on the date of loss of coverage, 44 days from the date coverage is lost. Information regarding alternative coverage and conversion rights is no longer required to be included in the election notice. The plan administrator is permitted to identify the qualified beneficiaries by their status instead of their names. The DOL has provided a model election form that is deemed compliant with COBRA.

Unavailability Notice. Plan administrators are now required to furnish an "unavailability notice" to individuals who apply for, but are not eligible to receive, COBRA coverage. The unavailability notice must be provided to the ineligible individual within 14 days of receipt of a qualifying event notice. The DOL has not provided a model unavailability notice.

Early Termination Notice. The new regulations also mandate that plan administrators issue "early termination" notices to individuals receiving COBRA coverage when such coverage ends before the expiration of the applicable maximum period of coverage. Notably, the regulations do not require coverage to continue until the early termination notice is delivered. To reduce administrative costs, the early termination notice may be packaged with the certificate of creditable coverage required under HIPAA. The DOL has not provided a model early termination notice.

Next Steps

- Most plans should replace their existing notices and begin using the models provided by the DOL. However, certain plans (such as multiemployer plans) will need to customize the DOL models.
- Decide whether it would be advantageous to combine the general notice with the SPD.
- Review your notices and procedures to ensure they meet the timing requirements specified in the regulations — requirements vary depending on whether the plan uses the date of loss of coverage or the qualifying event as the trigger.
- Develop reasonable written procedures for participants and beneficiaries to use to notify the plan of certain qualifying events.
- If using a third party to administer COBRA compliance, obtain written confirmation that such third party will comply, in all respects, with the new regulations.

IRS Delays the Effective Date of Its Relative Value Regulations (at Least for Some Plans)

At the end of 2003, the IRS issued final regulations that expand the information required to be included in notices describing qualified joint and survivor annuities (QJSAs) and qualified pre-retirement survivor annuities (QPSAs). These regulations, which were set to be effective as of July 1, 2004 for QPSA notices, and October 1, 2004 for QJSA notices, require that pension plan sponsors disclose to participants the "relative value" of various optional forms of benefits provided. In Announcement 2004-58, the IRS delayed the effective date of these final regulations for some plans.

The regulations are intended to provide participants with a better understanding of the optional forms of benefits available to them. Specifically, the regulations require that QJSA and QPSA notices contain numerical calculations comparing the value of the various forms of benefits available. The regulations permit plans to use either hypothetical examples or participant-specific information. The notices will, therefore, illustrate to participants the dollar effect of the subsidization of certain forms of benefits.

IRS Announcement 2004-58 generally provides that the relative value regulations will apply to annuity starting dates beginning on February 1, 2006. However, because QJSA notices are distributed between 30 and 90 days prior to a participant's annuity starting date, revised notices will need to be prepared by no later than the end of 2005. This delayed effective date will not, unfortunately, apply to all plans.

The IRS announcement states that the effective date of the relative value regulations is not delayed for plans that provide lump sum benefits (or other optional forms subject-to Section 417(e)(3) of the Internal Revenue Code) that are not actuarially equivalent to a QJSA. For plans that subsidize the QJSA, compared to certain other optional forms, the effective date of the relative value regulations remains October 1, 2004. Thus, plan administrators must act quickly to determine whether they can benefit from the delayed effective date.

IRS Sanctions Broader Use of "Negative Elections" Under 401(k)/403(b) Plans, but DOL Rules Still a Problem

Recent guidance from the IRS indicates that it supports a broader use of automatic enrollment features (also referred to as "negative elections") in 401(k) and 403(b) plans. The IRS had previously indicated that negative elections would be allowed, if an employee has an effective opportunity to elect to receive the deferred amount in cash. The employee has such an opportunity if he or she receives notice of the availability of the election and has a reasonable amount of time before the cash is currently available to make the election. In addition, the employee must have the right to change the election in the future, including the amount of the contributions. Such guidance seemed to suggest, however, that negative elections should be limited to 3% or 4%.

In a General Information Letter issued March 17, 2004, the IRS clarified that an employer can specify any percentage permitted under its plan as the negative election default amount. This means an employer may choose any level, whether it be the percentage necessary to generate the maximum plan match or simply a higher percentage (such as 6% or 7%), which it deems an appropriate avenue for achieving long-term savings goals. Additionally, if applicable notice requirements are met, the negative election percentages may increase over time, or in step with increases in an employee's compensation.

It is worth mentioning that the information letter cites Rev. Rul. 2000-8 and Rev. Rul. 2000-35, involving negative elections in 401(k) and 403(b) plans, respectively; it does not, however, mention Rev. Rul. 2000-33, involving the use of negative elections in 457

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IRS Sanctions Broader Use of "Negative Elections" Under 401(k)/403(b) Plans, but DOL Rules Still a Problem

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plans. Nevertheless, it would seem that the same reasoning should apply to 457 plans.

While the IRS continues to show greater support for the use of negative elections, it is important to remember, if negative elections are used to enroll employees in participant-directed defined contribution plans, that the Department of Labor has taken the position that ERISA Section 404(c) protection does not apply to a negative or default election. Section 404(c) generally protects plan fiduciaries from liability with respect to participant investment decisions under a participant-directed defined contribution plan that meets the requirements of Section 404(c). Therefore, an employer that wants to use negative elections must accept fiduciary responsibility for default investments. It is possible (but not entirely clear) that the plan fiduciary might be entitled to a relaxed fiduciary standard if the default investment is incorporated in the plan document.

With this continued fiduciary responsibility in mind, there appear to be three alternative investments that an employer might offer as the default investment: (1) a "safe" investment (a money market or stable value fund), (2) a "good" investment (a balanced fund or blended index fund) or (3) a managed account. Each choice has positive and negative features. The "safe" investment eliminates the risk of principal loss and encourages participants to move their money out of the "safe" investment due to the low rate of return, thus quickly eliminating the employer's fiduciary responsibility. However, there is a possible risk of future claims if, due to inertia and fear, participants leave their contributions in the money market or stable value fund for the long term and therefore experience a lower than average rate of return. If a "safe" investment is used as the default investment, it would be advisable for the plan administrator to establish a rigorous follow-up procedure to obtain affirmative investment elections from all participants.

A "good" investment is one that makes sense for the long term. If properly selected, such an investment will deliver a decent return without excessive risk. On the downside, using a balanced fund or blended index fund as the plan's default investment increases the likelihood that participants will not move their money, thus prolonging the employer's fiduciary responsibility. Additionally, there is a greater risk of principal loss than with a "safe" investment and, therefore, a greater risk of future claims, although arguably the choice is more defensible against such a claim than a "safe" investment. Because one size does not fit all, this type of default alternative encourages the use of "life cycle" funds that alter the investment mix based on the participant's age. However, age alone does not prescribe the best style of investing for all people. Because a "good" investment functions best when numerous personal characteristics of the investor are taken into account, including risk tolerance, age, health, investment horizon, planned expenditures, etc., such an investment choice may be problematic as the plan's default investment. As the plan's default, this alternative would be provided to the very people for whom such information has not been obtained.

Finally, a plan might choose a managed account as its default. In a managed account participant contributions are placed in a blended account that is individually designed based on age and other factors, if available (e.g., risk tolerance, other assets/investments, family needs, etc.). The selections can be made mechanically, by using a formula or software, or by a personal manager. This option is arguably much more likely to produce the optimal portfolio for each participant and shifts the employer's risk from investment selection to manager selection and monitoring. On the downside, managers' fees make it harder to produce optimal returns; some styles/managers perform better than others, and monitoring can be difficult. Additionally, as with the balanced and life cycle funds, individualized information about the investor is unlikely to be known. Thus, the managed account will likely be less effective if used as a default mechanism.

With these issues in mind, employers should feel confident that any negative election option provided in their 401(k) and 403(b) plans will be positively received by the IRS. At the same time, employers should continue to carefully consider the additional fiduciary liability exposure associated with default investments. Because a disconnect seems to exist between the lack of employee involvement required in the use of negative elections and the necessary employee participation required to achieve Section 404(c) protection with respect to plan investment choices, employers need to weigh the advantages and drawbacks of automatic enrollment approaches. Employers may also wish to explore mechanisms for obtaining affirmative investment elections from automatically enrolled participants.

The IRS Issues More HSA Guidance

The IRS has recently issued four new pieces of guidance regarding health savings accounts (HSAs). On May 11, 2004, the IRS issued Revenue Ruling 2004-45 addressing how HSAs interact with health flexible spending arrangements (health FSAs) and health reimbursement arrangements (HRAs). On June 25, 2004, the IRS issued Notice 2004-43, which provides transition relief for individuals in states where high-deductible health plans (HDHPs) are not available because state laws require health plans to provide certain benefits without regard to a deductible or below the minimum annual deductible applicable to HDHPs under Internal Revenue Code Section 223. The transition relief covers months before January 1, 2006 for state law requirements in effect on January 1, 2004. Also on June 25, 2004, the IRS issued sample forms to be used by HSA trustees and custodians with respect to HSA assets. Most recently, on July 27, 2004, the IRS released Notice 2004-50, which sets forth 88 questions and answers relating to the implementation and administration of HSAs.

■ Rev. Rul. 2004-45 sets forth four examples of situations in which an otherwise HSA-eligible individual who is covered by a HDHP and by a health FSA or HRA can make HSA contributions, and one example in which HSA contributions would not be permitted. The examples are summarized below.

Permissible Arrangements

- ***Limited Purpose FSA or HRA.*** An individual covered by a HDHP and a health FSA or HRA that only reimburses for expenses related to permissible insurance, permissible coverage or preventive care benefits may make HSA contributions.

- ***Post-Deductible Health FSA or HRA***. An individual covered by an HDHP and a health FSA or HRA that does not pay or reimburse any medical expense incurred before the HDHP minimum annual deductible is satisfied (other than permissible insurance, permissible coverage or preventive care expenses) may make HSA contributions.

- ***Retirement HRA***. An individual covered by an HDHP and a retirement HRA that pays or reimburses only those medical expenses incurred after retirement (other than permissible insurance, permissible coverage or preventive care expenses) may make HSA contributions.

- ***Suspended HRA***. An individual covered by an HDHP and an HRA, but who elects, before the beginning of the HRA coverage period, to forego payment or reimbursement of medical expenses during that coverage period, and whom the HRA does not pay or reimburse at any time for any medical expense incurred during the suspension period (other than preventive care, permitted insurance and permitted coverage expenses), may make HSA contributions.

Impermissible Arrangement

- An individual covered by an HDHP and by a traditional health FSA or HRA that reimburses all medical expenses may not make (or have made on his or her behalf) HSA contributions because a traditional health FSA or HRA reimburses medical expenses before the HDHP deductible is satisfied. The same answer applies to the extent the individual covered by the HDHP is also covered by his or her spouse's traditional health FSA or HRA.

Under Notice 2004-43, the IRS provides transition relief for plans that would otherwise be treated as HDHPs but for state-mandated benefit requirements. Pursuant to Notice 2004-43, such plans will be treated as HDHPs and eligible individuals covered by such plans will be permitted to make contributions to HSAs during the transition period. The transition period applies for months before January 1, 2006 for state laws in effect on January 1, 2004.

Form 5305-B (trust account) and Form 5305-C (custodial account) are model forms that may be used by HSA trustees and custodians.

- The forms must be signed by the HSA owner and the trustee or custodian and are not filed with the IRS. The forms may be customized with additional provisions relating to rollovers, investment rights and distribution procedures. However, the forms are not intended to be used on a stand-alone basis until they are finalized.

- The forms make clear that it is the HSA owner's responsibility to represent that he or she is covered by an HDHP and that the trustee/custodian may rely on that representation. In addition, it is the HSA owner's responsibility to determine whether the HSA contributions have exceeded the maximum annual limit.

In Notice 2004-50, among other things, the IRS clarifies that the HSA owner controls the HSA funds, provides guidance regarding family deductibles and HSA contribution limits where there are embedded individual deductibles, makes clear that employee assistance programs are permissible, supplements the safe harbor definition of preventive care set forth in Notice 2004-23 by including treatment that is ancillary to preventive procedures and certain drug therapies, and rules out providing employer "matching contributions" to an employee's HSA, except through a cafeteria plan, subject to Internal Revenue Code Section 125 nondiscrimination rules.

PBGC Announces Voluntary Correction Program for Participant Notice Failures

On May 7, 2004, the Pension Benefit Guaranty Corporation (PBGC) issued a notice announcing a Participant Notice Voluntary Correction Program (VCP) to correct failures by plan administrators to comply with Section 4011 of ERISA.

In general, ERISA Section 4011 requires certain underfunded defined benefit pension plans to provide written notice to participants as to the plans' funding status and the limits on the PBGC's guarantee. In general, notice is required if a variable rate premium is payable to the PBGC for a plan year as a result of the plan's underfunded status. The notice reflects the PBGC's concern that, as a result of a temporary change to the premium interest rate made under the Job Creation and Worker Assistance Act of 2002, certain plans may have been subject to the participant notice requirements for their 2002 or 2003 plan years even if a variable rate premium was not payable for that year. The VCP has been established as a temporary program aimed at failures to provide notices for plans' 2002 and/or 2003 plan year that were due prior to May 7, 2004 and are not subject to a current PBGC audit.

Under the VCP, a plan administrator can avoid the assessment of penalties if (i) a corrective notice in accordance with the VCP is issued no later than the due date for the 2004 notice and (ii) notice is provided to the PBGC within 30 days thereafter that the plan is participating in the VCP. The PBGC's published notice also states that if a plan administrator complies with the VCP, no penalties for pre-2002 plan year notice failures will be assessed. In order to encourage use of the VCP, the PBGC further notes that the risk of a plan audit will not increase as a result of its use. The participants to whom the corrective notice need be provided are only those participants (including beneficiaries of deceased participants, alternate payees and unions) who would be entitled to receive a 2004 notice, whether or not a 2004 notice is required.

Regardless of whether the plan administrator is correcting a 2002 or a 2003 failure, the corrective notice to participants (i) must include the funded current liability percentage for both

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EXECUTIVE COMPENSATION AUDIT INITIATIVE

Over the past year, the IRS has indicated an increased attention to executive compensation arrangements. The IRS has been concerned that executives have been using their employers as "piggy banks" and that employers and executives have been taking impermissibly aggressive (or perhaps careless) positions that significantly underreport income and minimize taxes.

Specifically, last year the IRS began internally training auditors to gear up for this initiative. In November 2003, the IRS publicly announced an audit initiative focusing on the executive compensation practices of 24 large corporations. The audit is an operational audit and is not limited to a review of plan documents. In addition, the IRS is not only reviewing corporate tax returns but is seeking copies of senior executives' personal returns as well. The initiative began as an "information finding" exercise in which the IRS focused on the following eight areas:

- *Nonqualified Deferred Compensation Arrangments* — A nonqualified deferred compensation arrangement is one in which an executive defers a portion of his or her income to a future date pursuant to an arrangement that is not covered by the tax-qualification requirements of the Internal Revenue Code. The employer may also make contributions to the arrangement. The arrangement can be either unfunded or funded through a rabbi trust; in either case, the employer's obligation is not secured and is subject to the claims of the employer's creditors. If the arrangement is structured properly, income is deferred for tax purposes until the date the amount is actually paid to the executive. In its initiative, the IRS is focusing on the timing of employer deductions and the executive's recognition of income and whether the doctrines of constructive receipt and economic benefit are properly applied in these arrangements (i.e., that there is an appropriate "matching" of income and deduction as to taxable year and amount).

- *Split-Dollar Life Insurance Arrangements* — A split-dollar life insurance arrangement is an arrangement pursuant to which the employer and the executive have certain entitlements to a life insurance policy purchased on the life of the executive. There are two main types of split-dollar life insurance arrangements: the collateral-assignment arrangement and the endorsement arrangement. A collateral-assignment arrangement is generally structured to provide that the employer is obligated to pay the majority of the premiums over a specified period of time on a life insurance policy owned by the executive. At rollout, the employer is repaid its aggregate premium contributions (but generally not earnings) and the executive retains the life insurance policy with the remaining cash buildup in the policy. In an endorsement arrangement, the employer is the owner of the life insurance policy and at rollout the employer may transfer the policy to the executive after withdrawing its premium contributions. The IRS is focusing on the proper reporting of income by executives in light of the IRS's guidance on split-dollar life insurance arrangements (which require some degree of income recognition by the executive).

- *Section 280G* — Section 280G of the Internal Revenue Code limits an employer's tax deduction on certain "change in control" payments made to corporate executives and certain other individuals providing services to the employer. Section 4999 of the Internal Revenue Code imposes a 20% nondeductible excise tax on such individuals for these payments. The IRS is reviewing these arrangements to determine whether Sections 280G and 4999 of the Internal Revenue Code have been properly applied.

- *Section 162(m) Compliance* — With certain exceptions (principally, performance-based compensation that has been approved by shareholders), Section 162(m) of the Internal Revenue Code imposes a limit of $1,000,000 on the amount of compensation a publicly held corporation may deduct for amounts it pays to its chief executive officer and the next four highest paid executive officers. The IRS is examining whether corporations have properly applied the 162(m) compensation limit.

- *Equity Compensation* — Many corporations provide their executives with stock-based compensation, which may take the form of stock options, stock appreciation rights, restricted stock or stock units. The tax consequences to the executive will vary depending on the type of stock-based award the executive receives and the date of exercise, vesting or payment, as applicable. The IRS is reviewing whether executives have properly recognized income on these awards, and is examining the timing and amount of corporate deductions.

- *Fringe Benefits* — Many corporations provide their executives with corporate perks, such as housing allowances, use of corporate aircraft, automobile allowances, and country club memberships. Many of these corporate perks are not specifically excluded from taxation under the Internal Revenue Code and therefore would be treated as taxable income to the executive. The IRS is focusing on whether these corporate perks have been properly valued and reported.

- *Family Limited Partnerships* — A number of executives have established arrangements pursuant to which they transfer their stock options to limited partnerships for the benefit of their family members, and have taken aggressive tax positions that seek to limit ordinary income recognition or defer receipt of other income. The IRS views these arrangements as tax shelters, not deferred arrangements, and is examining these arrangements in light of this position.

- *Asset Protection Plans* — Some executives have established professional service corporations to avoid employment and income taxes. These arrangements usually involve employee leasing programs and offshore deferred compensation arrangements. The IRS finds these arrangements impermissible and is examining these arrangements.

Recent informal comments from IRS officials indicate that the audit is likely to expand to a broader scope and become more aggressive as a result of the IRS's initial findings and because of the IRS's perception of significant noncompliance by employers. Problems have been uncovered mostly in the areas of taxation and deduction relating to nonqualified deferred compensation arrangements, stock-based compensation, compliance with the requirements of Section 162(m) of the Internal Revenue Code and corporate fringe benefits.

More companies' executive compensation arrangements are now likely to be audited in connection with the normal corporate audit process. As a result, it is recommended that companies consider conducting internal audits on their executive compensation arrangements to determine their compliance with the Internal Revenue Code. Such internal audits

should include reviewing tax reporting procedures and plan documentation and correcting any deficiencies through the available IRS correction procedures. Correcting any problems prior to IRS discovery may help to minimize the company's exposure on audit and reduce any potential penalties to the executive and the company. Such action may also help to minimize audit exposure for future years.

Pennsylvania Taxation of Deferred Compensation

Under federal tax rules, an employee contribution to a tax-qualified 401(k) plan under a salary reduction agreement is considered a pre-tax contribution and, as such, is not included in the employee's taxable income for federal income tax purposes for the taxable year in which the deferred amount is contributed. Similarly, amounts an employee elects to defer to a nonqualified employee benefit plan will not be included in the employee's taxable income for the taxable year of deferral unless the employee is in "constructive receipt" of the amounts deferred. Deferrals to a 401(k) plan will be included in the employee's taxable income upon distribution. Deferrals under a nonqualified plan will be taxable when received by or otherwise made available to the employee.

Tax treatment at the state level of amounts an employee elects to defer to a qualified or nonqualified employee benefit plan may be different from how such amounts are taxed at the federal level. Pennsylvania, in particular, includes in an individual's taxable income amounts he or she elects to contribute to a "retirement benefit plan" in the year of election instead of the year such amounts are distributed from the plan to the employee.

While Pennsylvania's position on elective deferrals to 401(k) plans was well-known, it was less clear whether it extended to nonqualified plans. A recent Pennsylvania case, *Ignatz v. Commonwealth of Pennsylvania,* 2004 Pa. Commw. LEXIS 385 (Pa. Commw. Ct. 2004), endorsed the extension of Pennsylvania's tax scheme to deferrals made to unfunded, nonqualified plans when the court upheld the assessment of personal income tax on compensation deferred by the taxpayers to such plans.

The taxpayers, pursuant to the terms of their employer's nonqualified retirement plans, elected to defer portions of base salary and bonuses by executing an irrevocable election in a period prior to when the compensation was earned. As a result of the election, the taxpayers had no right to receive, without penalty, the deferred amount until the date specified in the election. Each taxpayer's account under the employer's retirement plan constituted an unfunded obligation payable from the employer's general funds, and the taxpayer was accorded the status of an unsecured creditor of the employer.

The taxpayers did not include as income on their Pennsylvania tax returns amounts they elected to defer to the nonqualified plans. The Pennsylvania Department of Revenue increased the taxpayers' gross compensation by adding the deferred compensation and assessing penalties and interest, concluding that such amounts were constructively received by the taxpayers in the year they elected to defer such amounts.

The taxpayers argued that their voluntary contributions to their employer's nonqualified plans should not be compensation subject to Pennsylvania personal income tax in the year such amounts were contributed to the plans. The taxpayers further questioned whether the inclusion of such amounts violates constitutional uniformity when employer-mandated deferrals are not taxable in the year deferred.

The Commonwealth contended that Pennsylvania's taxing scheme is to tax personal income when it is contributed to deferred compensation and retirement plans pursuant to a voluntary salary reduction agreement. Further, the Commonwealth maintained that constitutional uniformity results from imposing equal tax burdens on all taxpayers who earn the same income.

The court began its analysis by noting that Pennsylvania imposes a personal income tax on every dollar of income that a resident receives during a taxable year. 61 Pa. Code § 302(a). Income is constructively received by a taxpayer in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time. 61 Pa. Code § 101.7(a).

The court rejected the taxpayers' argument that because the wording of the commonwealth's constructive receipt doctrine is virtually identical to the federal constructive receipt doctrine set forth in Treas. Reg. § 1.451-2(a), the commonwealth has effectively adopted federal law, and thus the federal interpretation of constructive receipt should govern to exclude the deferred compensation from income until it is distributed to the taxpayer. Moreover, the court agreed with the Commonwealth's contention that under the Pennsylvania rule of constructive receipt, amounts are taxable in the year when the taxpayer has the right to receive them, and the taxpayer's ability to elect whether to take the full amount in cash or take part in cash and contribute the balance to a deferred compensation plan establishes the requisite control over the compensation to establish constructive receipt.

The court described other instances in which it rejected the application of federal tax principles to the Pennsylvania tax scheme, including instances where the court addressed the assessment of Pennsylvania personal income tax on contributions to tax-qualified employee benefit plans.

The *Ignatz* court found that there was nothing to distinguish the personal income tax treatment of amounts deferred pursuant to the unfunded deferral arrangements at issue from the treatment of contributions to a funded plan. The court noted that but for the taxpayers' elections to defer receipt of income, the deferred amounts would have been received and thus are taxable for Pennsylvania personal income tax purposes at the time they would have been received absent an election otherwise. Finally, the court found that by including in income all amounts electively deferred pursuant to a funded or unfunded deferred compensation plan, the commonwealth promotes uniformity of taxation through its rule of constructive receipt.

As a result of this decision, we recommend that employers sponsoring nonqualified deferred compensation plans covering employees in Pennsylvania review their state withholding and reporting policies regarding elective deferrals and plan distributions.

SUPREME COURT HOLDS THAT PATIENTS CANNOT SUE HMOS FOR MALPRACTICE IN STATE COURT

The Supreme Court, reversing the Fifth Circuit, has ruled that patients cannot sue health maintenance organizations (HMOs) in state court when they are denied benefits ordered by their doctors.

Two participants sued their respective HMOs for negligence under Texas state law, alleging that the HMOs refused to cover their treatments even though they had been ordered by their physicians. One participant had to accept a cheaper painkiller after his HMO refused to cover the painkiller prescribed by his doctor. The participant later developed internal bleeding. The other participant was denied an extended hospital stay as ordered by her doctor. She was later forced to return to the hospital for emergency treatment.

The participants relied heavily on the Court's decision in *Pegram v. Herdrich*, contending that *Pegram* established that suits such as the participants' do not relate to an employee benefit plan, and, therefore, are not preempted by ERISA. The Court concluded in *Pegram* that HMOs were not to be treated as fiduciaries to the extent that they made mixed eligibility and treatment decisions through their treating physicians. In those cases, the HMOs and their physician employees could be sued in state court for malpractice. In this case, however, the Court determined that the HMOs were merely making benefit determinations, which are fiduciary acts connected to the administration of the plan; such acts fall squarely within the scope of ERISA. Accordingly, the Court held that the participants' causes of action were completely preempted by ERISA. *Aetna Health, Inc. v. Davila.*

SUPREME COURT FINDS THAT PLAN AMENDMENT VIOLATED ANTI-CUTBACK RULE

The Supreme Court has ruled that a pension fund violated ERISA's anti-cutback rule when it expanded the post-retirement employment categories that triggered suspension of early retirement benefit payments. The Court upheld a decision by the Seventh Circuit.

Certain participants in the multiemployer pension fund had elected to retire early. At the time of their retirement, the plan provided that retirees under age 60 were subject to suspension of benefits for periods of disqualifying employment. After retiring, the participants took jobs as construction supervisors, positions not considered disqualifying employment under the plan. The plan was later amended to broaden the definition of disqualifying employment to include any position in the construction industry.

The question before the Court was whether a new condition can be imposed after a benefit has accrued and whether the right to receive certain benefits on a certain date may be limited by a new condition narrowing that right.

The Court observed that the participants worked and accrued retirement benefits under a plan with terms allowing them to supplement retirement income by certain employment, and the participants were reasonable in relying on those plan terms in planning for retirement. The Court found that the "amendment undercut any such reliance, paying retirement income only if [the participants] accepted a substantial curtailment of [their] opportunity to do the kind of work [they] knew." The Court held that ERISA's anti-cutback provisions flatly prohibit plans from attaching new conditions to benefits that employees have already earned. *Central Laborers' Pension Fund v. Heinz*.

SUPREME COURT FINDS THAT YOUNGER WORKERS CANNOT PURSUE ADEA CLAIM AGAINST EMPLOYER THAT FAVORED OLDER WORKERS

The Supreme Court has found that a group of employees cannot pursue an action under the Age Discrimination in Employment Act (ADEA) alleging that their employer discriminated against them in favor of older workers. Reversing the Sixth Circuit, the Court held that the ADEA does not prohibit an employer from favoring older employees over younger employees.

Employees aged between 40 and 49 filed suit after a collective bargaining agreement (CBA) between their employer and their union was amended to eliminate the employer's obligation to provide health benefits to employees who subsequently retired. The amended CBA did not eliminate retiree health care, however, for then-current workers who were at least 50 years old.

Relying on the ADEA's plain language and legislative history, the Court explained that the ADEA is directed at protecting "workers who are older than the ones getting treated better." The Court determined that there was nothing in the legislative history to suggest that any workers had registered complaints about discrimination in favor of their seniors. If Congress had been concerned with protecting younger workers against older workers, the Court explained, "it would not likely have ignored everyone under 40. The youthful deficiencies of inexperience and unsteadiness invite stereotypical and discriminatory thinking about those a lot younger than 40, and prejudice suffered by a 40-year-old is not typically owing to youth, as 40-year-olds sadly tend to find out. The enemy of 40 is 30, not 50." *General Dynamics Land Systems, Inc. v. Cline.*

SUPREME COURT HOLDS THAT A WORKING OWNER OF A BUSINESS QUALIFIES AS A PARTICIPANT IN A PENSION PLAN GOVERNED BY ERISA

The Supreme Court has determined that a working owner of a business qualifies as a participant in an ERISA-governed pension plan.

The petitioner was a physician who was the sole shareholder and president of a professional corporation. The owner borrowed money from retirement plans maintained by the corporation but failed to make any payments on the loans. Three weeks before the owners' creditors filed an involuntary bankruptcy petition against him, the owner repaid the plan loan in full, using proceeds from a home sale. The creditors argued that the physician, as a self-employed shareholder, was not a "participant" within the meaning of ERISA and, therefore, could not rely on ERISA's anti-alienation provision.

The question before the Court was whether a "working owner" of a business qualifies as a "participant" in an ERISA-covered plan. The Court, finding ERISAs' definitions of "employee" and "participant" uninformative, looked to other provisions of ERISA and analyzed Congress' intentions in enacting ERISA. The Court found that prior to ERISA, the Internal Revenue Code

allowed working shareholders to participate in tax-qualified pension plans, and Congress' objective was to "harmonize ERISA with longstanding tax provisions." The Court pointed to several examples of how Title I of ERISA expressly contemplates the participation of working owners in covered benefit plans. The Court also relied on provisions of the Code and Title IV of ERISA to illustrate that under ERISA,

"a working owner may have dual status, *i.e.*, he can be an employee entitled to participate in a plan and, at the same time, the employer (or owner or member of the employer) who established the plan." Finally, the Court cited a Department of Labor advisory opinion that finds it was Congress' design to include "working owners" in the definition of "participant" under Title I of ERISA to support its conclusion. The Court held that if a plan covers one or more employees other than the business owner and his or her spouse, the working owner may participate on equal terms with other plan participants. *Yates v. Hendon.*

Fiduciary Duty Not Breached Where Employee Was Unaware of Enrollment Requirements That Were Explained in Materials Provided to Him

The Fourth Circuit affirmed a decision finding that an employer did not breach its fiduciary duty to an employee even though the employee claimed that he was never informed that he had to enroll in the employer's plan.

The employer hired the employee in 1972 and informed him that he would receive retirement benefits. The employee assumed that he would automatically receive these retirement benefits and claimed to be unaware that he needed to complete an application to enroll in the plan. The employer asserted that, over a period of years, it had circulated numerous documents explaining the retirement plan's enrollment procedures. The employee never enrolled in the plan, however, and maintained that he did not know until February 1994 that he was not enrolled. The employee filed suit alleging that the employer had breached its fiduciary duty when it made his coverage conditional on enrollment, but did not adequately notify him of the application requirement.

The court recognized that there was conflicting evidence regarding whether the summary plan descriptions (SPDs) were properly distributed, but determined that the employer did not breach its fiduciary duty in any case. The SPDs were not the only means by which the employer attempted to inform the employee of the plan's enrollment requirements. The court also considered the employee's claim that the SPDs and other materials notifying him of the enrollment requirements were sent to him through the employer's campus mail and that this mail system did not satisfy the minimum standards for distribution. The court determined that, although campus mail was not equivalent to in-hand delivery, and the employer's evidence regarding the adequacy of campus mail could have been stronger, the employee was unable to prove that the campus mail system was inadequate. *Brenner v. Johns Hopkins University.*

District Court Rules That Market Timing Restrictions Are Permissible Under 401(k) Plan and Investment Contract

An Iowa district court has held that a 401(k) plan's daily cap on market-timed trading was permissible under the terms of the plan and the group annuity contract under which the employer acted as investment manager. This decision follows a New York district court's decision in *Straus v. Prudential Employee Savings Plan*, in which the court upheld the employer's right to adopt rules and procedures restricting investment elections and directions under its savings plan.

A participant engaged in heavy market-timed trading, which the plan did not prohibit. After determining that the trading was affecting its international separate accounts negatively, the employer imposed a daily $30,000 limit on market-timed trading in those accounts. The participant continued to engage in the transactions, however, despite the trading restriction.

The court found that the employer, as both investment manager and plan sponsor, had the authority to impose the trading cap. The court noted that the employer, as the plan's investment manager, was bound by its fiduciary duty to limit transactions that it believed were having a detrimental effect on its separate accounts. Although the plan document did not specifically authorize trading restrictions, it expressly deferred to the group annuity contract with respect to direction of contributions and transfers into the international separate accounts. The group annuity contract specifically authorized the employer, as investment manager, to defer or stop contributions among investment vehicles if certain criteria were met. Accordingly, the court found that the employer could rely on its authority under the group annuity contract and was not required to amend the plan in order to impose the trading restriction. *Borneman v. Principal Life Insurance Company.*

PBGC Announces Voluntary Correction Program for Participant Notice Failures

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2002 and 2003 and (ii) may include the funded current liability percentage for 2004. The notice must also contain current information on funding waivers, missed contributions, and limitations on the PBGC's guarantee. The PBGC has published a safe harbor participant notice for use by plan administrators who wish to utilize the VCP.

Under ERISA Section 4011, the PBGC may assess penalties of up to $1,000 per day for failures to comply with any notice requirements under Title IV of ERISA. In general, the current penalty policy with respect to failures to provide notices required under ERISA Section 4011 is $25 per day for the first 90 days and $50 per day thereafter. In this regard, the PBGC has also proposed a new penalty policy for failures to issue notices required by ERISA Section 4011.

Under this new policy, the penalty would equal the number of participants multiplied by a per-participant penalty rate. In general, this rate is $5 per participant ($20 per participant for repeat violations), or $40 per participant ($100 per participant for repeat violations) if the PBGC has issued written notice that it is auditing the plan's compliance with ERISA Section 4011. The number of participants to be used is generally the number used for determining the PBGC premiums under the plan.

The PBGC notice covering the VCP, which includes the safe harbor ERISA Section 4011 notice, is available online at http://www.pbgc.gov.

SAME-SEX MARRIAGES: POTENTIAL EFFECTS ON EMPLOYEE BENEFIT PLANS

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contract for an insured plan or stop-loss insurance contract for a self-funded plan.

- *Are there special issues involved in treating a same-sex spouse as a "spouse" under a tax-qualified retirement plan (401(k) plan, defined benefit plan, cash balance plan, money purchase plan, 403(b) plan)?*

Yes. Because the terms of such plans are heavily regulated by ERISA and the Internal Revenue Code, and because, as noted, those federal statutes would not recognize a same-sex spouse as a "spouse," employers must be cautious in electing to treat same-sex spouses as spouses under such plans. For example, conditioning an employee's selection of a benefit option or a death beneficiary on the consent of a same-sex spouse may jeopardize the plan's tax-qualified status.

- *How do same-sex marriages affect an employer that provides domestic partner benefits?*

An employer with employees in Masachusetts that extends benefits to domestic partners may want to consider whether such benefits should be eliminated in favor of "spousal" benefits for only those Massachusetts employees with same-sex partners who choose to get married (particularly where the policy does not cover Massachusetts opposite-sex domestic partners). For plans not covered by ERISA, it is unclear whether an employer that limits its domestic partner policy to same-sex domestic partners can continue to do so in Massachusetts in light of the Commonwealth's prohibition on discrimination on the basis of sexual orientation. Employers with employees in other states may wish to consider as well the impact of Massachusetts marriages on their domestic partner policies.

WHAT SHOULD EMPLOYERS DO?

All employers, but particularly those with employees in Massachusetts or in contiguous or nearby states, should take a number of immediate steps in response to these developments:

- Determine and monitor the status of Massachusetts same-sex marriages in the states where the employer has operations.
- Review all benefit plans and other relevant documents (SPDs, insurance contracts, handbooks/policy manuals) and consider whether and how those documents define "spouse," and whether they ought to be clarified or revised.
- If spousal benefits are to be extended to same-sex spouses, consider (i) relevant tax-reporting and withholding issues, (ii) whether such coverage is permitted under relevant insurance contracts, (iii) potential effects on status of tax-qualified retirement plans, and (iv) where employees are covered by a collective bargaining agreement, whether there is a duty to bargain with the union regarding such extension of benefits.
- Examine any domestic partner policies and consider whether those policies should be revised to the extent they apply to employees located in Massachusetts.

SELF-CORRECTING DELINQUENT CONTRIBUTIONS

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ANNUAL REPORT ON FORM 5500

The DOL requires a plan sponsor to disclose on Form 5500 whether it failed to timely deposit any participant contributions for the year. In circumstances where the plan sponsor answers the question affirmatively and the delinquent contribution has been corrected formally or informally, the plan sponsor may consider attaching a letter to the Form 5500 explaining the correction. Beginning in 2004, plan auditors are required to verify that the deposit requirements have been met, which may flush out many more violations.

CONCLUSION

The significant potential consequences of failing to meet the deposit deadline for participant contributions suggest that plan sponsors should adopt and follow administrative policies and procedures consistent with DOL requirements. If a plan sponsor concludes that there was a failure to timely deposit, it should carefully document all the relevant facts as well as any corrective action taken.

MORGAN LEWIS ON BENEFITS

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