



A quarterly newsletter about employee benefits and current issues

Fourth Quarter 2010

As usual, it has been a busy year in the benefits world. With the passage of the Affordable Care Act (“ACA”), as well as several other key pieces of legislation and regulatory guidance, there are many benefit changes set to take effect January 1, 2011 (at least for calendar-year plans). As year-end approaches, now is the time for plan sponsors to review their benefit plans to ensure that all of the necessary action items have been checked off the list. This issue of our quarterly newsletter is devoted to some of the more important changes that sponsors should address before the sun sets on 2010.



## **GROUP HEALTH PLAN REVIEW**

The passage of comprehensive health care reform legislation under the Affordable Care Act (“ACA”) made 2010 a monumental year for group health plans. As a result, plan sponsors are faced with a dizzying array of action items for 2011.

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## **YEAR-END DEADLINE FOR SECTION 409A CORRECTIONS**

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## **CAFETERIA PLAN CHANGES FOR 2011**

Amid the year-end rush to comply with the reform provisions of the Affordable Care Act (“ACA”) for group health plans, it is easy to overlook the ACA’s effects on other health care arrangements. Cafeteria plans, health flexible spending accounts (“FSAs”), health savings accounts (“HSAs”), and health reimbursement arrangements (“HRAs”) are subject to several of the same provisions that apply to group health plans.

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## **IN-PLAN ROTH CONVERSIONS NOW PERMITTED, BUT MANY QUESTIONS REMAIN**

On September 27, 2010, President Obama signed the Small Business Jobs and Credit Act of 2010 (the “Act”), which includes two provisions designed to promote retirement preparation (while raising revenue for the federal government). The first would permit Roth contributions to Section 457(b) plans maintained by state or local governments (a feature that is currently limited to 401(k) and 403(b) plans). The second would permit certain amounts in 401(k), 403(b) and governmental 457(b) plans to be converted to Roth accounts within the plan (*i.e.*, an “in-plan” conversion option).

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## **YEAR-END QUALIFIED PLAN CHECKLIST**

Sponsors of tax-favored retirement plans should keep in mind the many required amendments for which a 2010 year-end deadline is fast approaching, including the HEART Act, delayed PPA deadlines and more.

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## GROUP HEALTH PLAN REVIEW

The passage of comprehensive health care reform legislation under the Affordable Care Act (“ACA”) made 2010 a monumental year for group health plans. As a result, plan sponsors are faced with a dizzying array of action items for 2011.

### Grandfathered Status

The ACA introduced the concept of “grandfathered” health plans. As we discussed in our [June 2010 article](#), grandfathered plans are excused from at least some of the ACA’s requirements. Plan sponsors must decide whether their plans qualify as grandfathered plans and, if so, whether such status is worth preserving for the 2011 plan year in light of the restrictions it places on changes to plan design and cost-sharing arrangements.

Note that the agencies recently amended the regulations so that fully insured plans can remain grandfathered even if they change insurance carriers or policies (as long as no other changes are made that would otherwise cause a loss of grandfathered status). Thus, some plan sponsors who had already concluded that their plan would lose grandfathered status (due solely to an anticipated change in carriers) may wish to reevaluate that position. The amended regulations are prospective only. Plan sponsors who have already lost grandfathered status due to a change in insurance carriers or policies after the enactment of the ACA (March 23, 2010), but before the amended

regulations were issued (November 15, 2010), are not affected.

### Plan Design Decisions

Many aspects of the new ACA requirements are subject to interpretation, and other provisions leave some room for administrative flexibility. Plan sponsors should review their plan provisions and decide how they will apply the various ACA provisions. For example, group health plans may no longer place any lifetime dollar limits on “essential health benefits.” Right now, plan sponsors are subject to a “good faith” interpretation of the term “essential health benefits.” Thus, they must decide whether particular covered services, such as chiropractic care or infertility services, constitute essential health benefits, to which no lifetime limit may be applied.

### Plan Amendments

Once plan sponsors have made decisions regarding grandfathered status and plan design, the plan document must be amended to incorporate the required ACA changes. *All* group health plans, both grandfathered and non-grandfathered, must be amended to comply with the following ACA changes:

- ▶ Extend eligibility for dependent children to age 26;
- ▶ Eliminate lifetime benefit limits for “essential health benefits”;

- ▶ Revise and/or eliminate annual benefit limits for “essential health benefits”; and
- ▶ Eliminate pre-existing condition limitations for enrollees under age 19.

In addition, *non-grandfathered* plans must be amended to comply with the following ACA mandates:

- ▶ New internal claims and appeals requirements;
- ▶ New external review procedures;
- ▶ Eliminate cost-sharing for in-network preventive services; and
- ▶ Provide new patient protections for designation of primary care provider and emergency services.

## **Notices and Disclosures**

As we discussed in our [August 2010 article](#), there are many new notice and disclosure requirements under the ACA. Plan sponsors must ensure that all required notices and disclosures have been distributed. *All* group health plans, both grandfathered and non-grandfathered, must provide notice of:

- ▶ Removal of the plan’s lifetime benefit limit and the corresponding special enrollment opportunity; and
- ▶ Expansion of dependent eligibility and the corresponding special enrollment opportunity.

In addition, *grandfathered* group health plans must provide a special notice of the plan’s grandfathered status. *Non-grandfathered* plans must provide a special notice of the new patient protections governing designation of primary care provider, pediatrician, and OB/GYN. All of these notices must be distributed to participants on or before the first day of the first plan year beginning on or after September 23, 2010.

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## **CAFETERIA PLAN CHANGES FOR 2011**

Amid the year-end rush to comply with the reform provisions of the Affordable Care Act (“ACA”) for group health plans, it is easy to overlook the ACA’s effects on other health care arrangements. As discussed in our [May 2010 article](#), cafeteria plans, health flexible spending accounts (“FSAs”), health savings accounts (“HSAs”), and health reimbursement arrangements (“HRAs”) are subject to several of the same provisions that apply to group health plans. These include:

- ▶ Coverage of “adult children”; and
- ▶ Elimination of reimbursements for over-the-counter medications purchased without a prescription.



The ACA also created a nondiscrimination “safe harbor” for cafeteria plans maintained by certain small employers.

## **Coverage of Adult Children**

Effective March 30, 2010, FSAs and HRAs may allow tax-advantaged contributions and reimbursements for an employee’s child who will not have attained age 27 by the end of the calendar year. Moreover, employees may be allowed to make pre-tax premium payments on behalf of such “adult children.”

These pre-tax reimbursements and premiums may be made in 2010 even if the cafeteria plan has not yet been amended to reflect that option. However, such an amendment must be adopted by December 31, 2010, and it must be retroactively effective as of the first date that employees were permitted to obtain pre-tax reimbursements or make pre-tax premium payments on behalf of their adult children (but in no event earlier than March 30, 2010).

## **Restrictions on Reimbursements**

Beginning on January 1, 2011, expenses for over-the-counter drugs (other than insulin) may not be reimbursed from an FSA, HSA, or HRA unless prescribed by a physician. Employers should review any of their arrangements that currently allow for reimbursement of over-the-counter drugs to determine whether an amendment is necessary to comply with this restriction. If such an amendment is necessary, employers will have until June 30, 2011, to adopt it. That

amendment should then be made retroactive to January 1, 2011.

## **Safe-Harbor Nondiscrimination Rule for SIMPLE Cafeteria Plans**

Effective January 1, 2011, the ACA establishes a “SIMPLE cafeteria plan” for certain small employers. To be eligible to sponsor such a plan, an employer must have employed an average of 100 or fewer employees for each of the past two years. (This limit may be exceeded by a “growing employer,” up to a limit of 200 employees.) A SIMPLE cafeteria plan provides a “safe harbor” from the Tax Code’s nondiscrimination requirements for cafeteria plans, as well as from the nondiscrimination requirements for specified qualified benefits offered under such a plan, such as group-term life insurance, benefits under a self-insured medical expense reimbursement plan, and dependent care assistance.

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## **YEAR-END QUALIFIED PLAN CHECKLIST**

As we reported in our [August 2010 article](#), sponsors of tax-favored retirement plans should keep in mind the many required amendments for which a 2010 year-end deadline is fast approaching.



## HEART Act

Most tax-favored retirement plans must be amended by the end of the 2010 plan year to reflect the mandatory provisions of the Heroes Earnings Assistance and Relief Tax Act of 2008 (the “HEART Act”). HEART Act changes for which amendments are required include:

- ▶ An enhanced survivor benefit; and
- ▶ New rules governing the treatment of military differential pay.

Many sponsors have already amended their plans for the HEART Act. But as we reported in our [March 2010 article](#), some plans may require a second round of HEART Act Amendments to address guidance issued by the IRS in [Notice 2010-15](#).

## Delayed PPA Deadlines

The amendment deadline for most changes required by the Pension Protection Act of 2006 (“PPA”) was the last day of the first plan year beginning on or after January 1, 2009. In [Notice 2009-97](#), however, the IRS extended the deadline for three categories of PPA amendments until the last day of the 2010 plan year. The following changes are affected by this delay:

- ▶ For certain *defined contribution* plans that invest in employer stock, new diversification rights for participants;
- ▶ For *defined benefit* plans, new funding-based limits on distributions and benefit accruals; and

- ▶ For *cash balance* and other hybrid plans, a number of new vesting and other special rules.

## Discretionary Amendments

In most cases, the deadline for adopting plan-design changes that do not reduce the rate of benefit accruals is the end of the plan year in which they take effect; *i.e.*, such changes may be retroactive to the first day of the plan year. Thus, for most purposes, calendar-year plans must be amended to reflect 2010 design changes by no later than December 31, 2010.

Some design changes must be adopted, however, *before* the plan year in which they take effect. These include certain changes to safe-harbor 401(k) contributions, as well as certain reductions in the rate of pension accruals. For such design changes to be effective for the 2011 plan year, they must therefore be adopted by the end of the 2010 plan year.

## Direct Rollovers for Nonspouse Beneficiaries

As a part of the PPA, Congress amended the rollover rules to allow nonspouse beneficiaries to roll death benefits directly into an individual retirement account or annuity. Despite some initial uncertainty, Congress has now made clear that this was a *mandatory* change.

Accordingly, all Section 401(a) qualified retirement plans, Section 403(b) plans, and governmental Section 457(b) plans have



been required to allow direct rollovers by nonspouse beneficiaries since January 1, 2010. In general, these plans must be amended to reflect this change by the end of the first plan year beginning in 2010.

### **Cycle E Filing Deadline**

Individually designed Section 401(a) qualified plans falling within “Cycle E” of the IRS’s determination letter program must be amended and restated — and have a determination letter application filed with the IRS — by January 31, 2011. The same is true for any governmental plan that chose not to submit a determination letter application during their regular cycle (Cycle C, which closed on January 31, 2009). A plan falls within Cycle E if the sponsoring employer’s tax identification number ends with either “5” or “0.” The sponsor of any Cycle E plan that has not already begun this review and amendment process should do so immediately.

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### **YEAR-END DEADLINE FOR SECTION 409A CORRECTIONS**

Employers and their executives should note a year-end deadline for correcting certain failures to comply with the “documentation” requirements of Section 409A of the Internal Revenue Code. As explained in our [March 2010 article](#), IRS Notice 2010-6 created a program for correcting such failures, but

with many of its generous transitional rules expiring on December 31, 2010. Given the IRS’s “evolving” position on certain Section 409A issues, even those employers whose nonqualified plan documents have already been reviewed and amended for compliance with this Code provision would be well-advised to take one more look at their documents before this transition relief expires.

### **Background of Section 409A**

Most employers are now familiar with Section 409A. It applies quite broadly, sweeping in not only traditional nonqualified deferred compensation arrangements (such as supplemental retirement programs, incentive compensation arrangements, and Section 401(k) “excess” plans), but also employment agreements, severance agreements, and certain equity compensation plans. IRS regulations make clear that, in order to comply with Section 409A, an employer must have appropriate written documents, and those documents must then be administered in accordance with their terms.

The penalties for failing to comply with Section 409A are onerous, falling primarily on executives and other employees who are entitled to receive the nonqualified deferred compensation. They include the immediate inclusion in taxable income of all vested amounts, an additional penalty tax equal to 20% of those taxable amounts, and interest assessments commencing from the dates each of those amounts became vested.



## **Notice 2010-6**

After finalizing its Section 409A regulations in the spring of 2007, the IRS announced a correction program for *operational* violations in late 2008 (Notice 2008-113). In early 2010, the IRS issued Notice 2010-6, the first (and still only) official guidance on correcting *documentation* failures. The key advantage of correction under Notice 2010-6 is that any correction is then deemed to have been made as of January 1, 2009, when documentary compliance with Section 409A became fully effective. This allows an employer to shield its executives from the onerous tax penalties.

Only certain documentation failures are eligible for the relief provided under 2010-6. Moreover, the Notice includes a one-year “look-back” provision. If a correction made under this Notice has no effect on a plan’s operation for one year thereafter (*e.g.*, because a distribution is to be made on an executive’s separation from service and the executive does not separate during that one-year period), the affected executive will generally escape any adverse tax consequences. If a plan’s operation *is* affected within one year after the correction is made, the Notice still provides for only a *partial* income inclusion (plus the 20% penalty tax on that partial amount) and no interest assessment.

Employers should recognize that correction under Notice 2010-6 may also require a simultaneous correction of an *operational* violation under Notice 2008-113. Corrections

of operational violations may have their own tax inclusion requirements.

Moreover, Notice 2010-6 conditions its relief on compliance with certain reporting requirements. An employer who corrects a documentation failure under this Notice must attach a statement to that effect to its income tax return and then provide a copy of that statement to all affected employees. Those employees must then attach that statement to their tax returns in order to enjoy the relief provided under this Notice.

## **Payments Conditioned on Signing a Release or Noncompete Agreement**

One of the surprises contained in Notice 2010-6 was a more restrictive interpretation of Section 409A’s application to a plan or agreement that conditions payment of deferred compensation on an employee signing either a release of legal claims or an agreement not to compete. Recognizing that such a condition could effectively give an employee discretion to determine the taxable year in which a payment will be made (simply by timing his or her signing of the release or noncompete agreement), many employers have amended their plans to assign this discretion to the *employer*.

Under the Notice, however, even such *employer* discretion is impermissible. To correct such a documentation failure, the Notice requires that the plan or agreement be amended to remove the discretion entirely. Instead, the plan must provide that any payment will be made on the last day of the



period allowed for signing the release or noncompete agreement. That period cannot be extended. Accordingly, if an employee fails to sign the release or noncompete agreement during the specified period, he or she must simply forfeit the deferred compensation.

Notice 2010-6 allows a plan to be amended to reflect this more stringent rule, but only if that amendment is adopted **before** the date of any distribution event to which the impermissible discretion relates. Thus, for instance, if an employment agreement conditions the payment of deferred compensation on the terminated employee signing a release of claims and/or a noncompete agreement, but does not sufficiently specify the date on which that deferred compensation will be either paid or forfeited, the employment agreement must be amended to specify this date before the employee separates from service. If it is not timely amended, the employment agreement would violate Section 409A, with the onerous tax consequences described above. For this reason, employers should promptly review their employment agreements to determine whether such corrective amendments might be needed.

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## IN-PLAN ROTH CONVERSIONS NOW PERMITTED, BUT MANY QUESTIONS REMAIN

On September 27, 2010, President Obama signed the Small Business Jobs and Credit Act of 2010 (the “Act”), which includes two provisions designed to promote retirement preparation (while raising revenue for the federal government). The first would permit Roth contributions to Section 457(b) plans maintained by state or local governments (a feature that is currently limited to 401(k) and 403(b) plans). The second would permit certain amounts in 401(k), 403(b) and governmental 457(b) plans to be converted to Roth accounts within the plan (*i.e.*, an “in-plan” conversion option).

### Roth 457(b) Contributions

Under current law, participants in certain tax-favored plans may designate their elective contributions as “Roth contributions.” Although Roth contributions are made on an “after-tax” basis, if the contributions satisfy a five-year holding period requirement and are distributed in a “qualified distribution,” the earnings on such contributions are tax-free.

Prior to the Act, Roth contributions were available only in 401(k) plans and 403(b) arrangements. Beginning January 1, 2011, however, governmental 457(b) plans may also adopt a Roth contribution feature. This will allow participants in such plans to elect that some or all of their deferrals be treated (and separately accounted for) as after-tax, Roth contributions.



## Roth IRA Conversions

Prior to the Act, the only way to change non-Roth retirement savings into Roth savings was to either (i) “convert” a traditional IRA into a Roth IRA, or (ii) roll non-Roth money from a tax-favored retirement plan (such as a 401(k), 403(b), or governmental 457(b) plan) directly to a Roth IRA. However, prior to 2010, taxpayers whose adjusted gross income (“AGI”) exceeded \$100,000 were not permitted to make an IRA conversion or to roll non-Roth retirement plan amounts into a Roth IRA.

Effective in 2010, that income limitation was eliminated. Beginning this year, regardless of their AGI, traditional IRA owners and participants in tax-favored retirement plans may roll non-Roth money directly to a Roth IRA, and this rollover will be treated as a taxable “conversion” of pre-tax amounts to after-tax, Roth amounts. Moreover, under a special rule, amounts that are converted during 2010 will be taxed ratably over two years, starting in 2011 (*i.e.*, the income recognition will be delayed and spread over two years) – unless the participant affirmatively elects to report the entire amount as taxable income in 2010.

## In-Plan Roth Conversions

Under the Act, participants in a tax-favored plan that has a Roth contribution feature may “roll” non-Roth amounts to a designated Roth account maintained within the same plan, and this “rollover” will be treated as a taxable conversion. However, there are

some significant limitations on this “in-plan Roth conversion” option.

- ▶ The plan offering the in-plan conversion option must be a 401(k) plan, a 403(b) plan, or (on or after January 1, 2011) a governmental 457(b) plan that includes a Roth contribution feature.
- ▶ The in-plan conversion option is limited to amounts that are otherwise “distributable” under the Tax Code and under the terms of the plan. This means that (1) employee pre-tax contributions may not be converted prior to separation from service unless the individual has attained age 59 1/2 *and* the plan permits (or is amended to permit) the in-service distribution of such amounts at that age, and (2) employer contributions (such as matching contributions) cannot be converted prior to separation from service unless the plan permits (or is amended to permit) the in-service distribution of such amounts on account of the attainment of a specified age or number of years of participation.
- ▶ The plan must be amended to specifically provide for Roth conversions.

The in-plan Roth conversion option is effective immediately (*i.e.*, plans may offer this option on or after September 27, 2010). However, that does not provide much time for plan sponsors to adopt plan amendments and draft appropriate participant communications (or for service providers to prepare to record keep and/or report such

conversions). Because of the special tax rules applicable to 2010 conversions (as well as the uncertainty regarding future tax rates), participants may be clamoring to make such conversions before the end of the 2010 plan year.

### **Adding an In-Plan Roth Conversion Feature**

Generally, plan amendments to reflect “optional” law changes (such as the in-plan Roth conversion option) must be adopted by the last day of the plan year in which the optional provision is first made effective. Thus, plan amendments to allow 2010 in-plan Roth conversions must generally be adopted by the last day of the 2010 plan year. However, according to the legislative history of the Act, Congress “intends” for the IRS to provide plan sponsors with a “remedial amendment period” that will allow sponsors to offer this conversion option in 2010, but with sufficient time (perhaps even beyond the last day of the 2010 plan year) to amend the plan to reflect the option.

The legislative history of the Act also indicates that it is Congress’s intent that plans may adopt “in-service” distribution provisions that are limited to in-plan conversions. For example, if a plan currently does not allow distributions of employee pre-tax contributions until separation from service, the plan could be amended to allow the distribution of such amounts upon attainment of age 59 1/2, but only if the participant “converts” those amounts into

Roth contributions within the plan (such that the money never actually leaves the plan).

Although this ability to restrict certain distributions to in-plan conversions is generally limited to *new* in-service distribution provisions (because imposing such a restriction on an existing in-service distribution feature would be an impermissible cut-back), this does allow plans to increase the amount of “convertible” money without exposing the plan to excessive “leakage.” Plan sponsors will need to watch for future guidance from the IRS regarding (i) when plans must be amended to reflect an in-plan conversion option that is effective in 2010, and (ii) the legality of limiting new in-service distributions to in-plan conversions.

### **Open Issues for Plan Sponsors (and Service Providers)**

Although certain plan participants may wish to make in-plan Roth conversions before the end of 2010 (either to take advantage of the special rule that allows the participant to spread the income over a two-year period beginning in 2011, or simply to recognize the income before tax rates increase), there are many open issues for plan sponsors (and service providers) who are considering adding this feature to their plans. These open questions include:

- ▶ Will the IRS actually provide (as suggested by Congress) a “remedial amendment period” for adopting plan



amendments (such that the plan does not have to be amended by the last day of 2010 to allow 2010 conversions)? If so, will that additional time also apply to amendments to add a Roth contribution feature in the first place, or to add additional in-service distribution options?

- ▶ Will the IRS actually allow plans to make additional amounts available only for in-plan conversion (but not for “distribution” from the plan), and if so, must an amendment be adopted before the plan allows such conversions (or will these types of amendments also be covered by the “remedial amendment period” discussed above)?
- ▶ Must the employer “withhold” on this taxable conversion? (Most commentators believe the answer is no, but confirmation would be helpful.)
- ▶ Must the plan report the distribution on Form 1099, and if so, how must it be coded? (Again, most commentators are assuming that the answer is yes, although there is less certainty regarding the proper code to report the conversion.)
- ▶ Must the converted amounts (and the earnings thereon) be held in a separate account from designated Roth contributions? (Most commentators believe the answer is yes, for a variety of reasons.)
- ▶ What steps must be taken to “complete” an in-plan conversion before the end of 2010 (i.e., is it sufficient for the participant to make a written election, or must some additional steps be taken by the plan or the plan’s service provider to demonstrate that the amounts have actually been “converted” to after-tax, Roth amounts)?
- ▶ Are there separate five-year holding periods for designated Roth contributions and converted amounts?
- ▶ If a plan requires spousal consent to distributions and/or loans, must it also require spousal consent to an in-plan Roth conversion?
- ▶ Can the portion of a participant's account that is a participant loan (i.e., a promissory note) be converted?

## Summary

Employers who currently sponsor 401(k) or 403(b) plans with Roth contribution features will need to decide (very soon) whether they wish to allow in-plan Roth conversions, and if so, whether they wish to make that feature available before the end of 2010. In addition, those same plan sponsors will need to decide whether they wish to amend their plans to make additional amounts available prior to separation from service, and whether those new in-service distribution options



should be limited to in-plan Roth conversions. Part of this decision-making may depend on whether (and when) the plan's administrator / recordkeeper will be able to accommodate such conversions.

Finally, employers who sponsor 401(k) or 403(b) plans that do not currently include a Roth contribution feature (as well as sponsors of governmental 457(b) plans) may want to consider adding both a Roth contribution feature *and* an in-plan Roth conversion feature (although governmental 457(b) plans cannot add those features until 2011).

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