



*Let us help you manage your benefits cost and risk.*

Monthly Newsletter – Volume 3, No. 7 – July 11, 2007

## Monthly Newsletter – Volume 3, No. 7 – July 11, 2007

### *Highlights of the Month*

- 1. First 401(k) Excessive Fee Case Dismissed**
- 2. Safe Harbor 401(k) Plan May be Amended Mid-Year to Reflect Recent Law Changes**
- 3. IRS Eliminates Schedule P to Form 5500**
- 4. IRS Issues Ruling on Partial Plan Termination**
- 5. IRS Issues Proposed Regulations on HSA Comparability Rules**
- 6. Court Holds that Retiree Medical Benefits Can be Coordinated with Medicare**
- 7. Court Rules that Plan Provision on Separated Spouses Does Not Violate ERISA or COBRA**
- 8. DOL Publishes Comments on FMLA**

### **First 401(k) Excessive Fee Case Dismissed**

On June 21, 2007 the U.S. District Court for the Western District of Wisconsin dismissed the complaint in *Hecker v. Deere* which alleged that the 401(k) fee arrangements violated ERISA.

#### *Background*

*Hecker v. Deere* is one of a series of cases alleging that plan sponsors have paid excessive fees to 401(k) service providers. The 401(k) plan sponsored by Deere & Co. is a participant directed plan, i.e., a plan where plan participants are able to direct the investment of the monies held in their plan account. The Deere plan offered 26 core investment options, 23 of which were managed by Fidelity. The plan also had a brokerage window that included over 2,500 publicly available mutual funds which were not affiliated with Fidelity. Deere paid Fidelity directly for the trust services it provided and the plan paid no fees to Fidelity.

If the provisions of ERISA § 404(c) are implemented correctly, then the Deere plan fiduciaries are not liable for the investment choices made by the plan participants. One of the requirements under ERISA § 404(c) is that the participants must receive sufficient information regarding the investment options under the plan in order to make informed decisions. While the plan fiduciaries may not be liable for the investment decisions made by the individual participants, they can still be liable for losses based on the funds they



*Let us help you manage your benefits cost and risk.*

make available to the plan participants and the disclosure of information regarding the investment funds that have been made available to the participants.

The *Deere* complaint set forth two basic claims:

- ❖ The plan sponsor violated ERISA disclosure and fiduciary requirements because it failed to disclose revenue sharing arrangements to participants; and
- ❖ The plan sponsor violated ERISA’s fiduciary provisions by “selecting and offering investment options with unreasonably high fees. . .”

### *The Decision*

The court assumed that the factual allegations contained in the complaint were true. Additionally, the court assumed that the plan sponsor did not disclose information about the revenue sharing arrangements to participants and that the plan sponsor could have negotiated lower fees with Fidelity or could have selected different funds from different providers with lower rates but made no effort to do so.

With respect to the first allegation, the court ruled that ERISA’s current disclosure requirements do not require the disclosure of revenue sharing or other indirect fee arrangements. In this regard, the court found it relevant that the amount of disclosure regarding revenue sharing arrangements is a matter that is currently being addressed by the U.S. Department of Labor’s Employee Benefits Security Administration (EBSA). Moreover, the court held that there is no fiduciary requirement – separate from ERISA’s disclosure rules – for that disclosure.

With respect to the second allegation, the court held that because the plan sponsor had met the requirements of ERISA § 404(c), the plaintiffs could not bring an action based on excessive fees, even if, as discussed above, it were assumed that plaintiffs could prove that the fees were excessive. In addition, the court found that the existence of the brokerage window insulated Deere from any charge that fees on the core funds were excessive. In discussing the 2,500 funds offered through the brokerage window, the court stated “[a]ll of these funds were also offered to investors in the general public so expense ratios were necessarily set to attract investors in the marketplace.” The court found that at least some of the funds offered through the brokerage window must have had reasonable fees.

It is unclear at this time whether the case will be appealed to the 7<sup>th</sup> Circuit Court of Appeals.



*Let us help you manage your benefits cost and risk.*

Monthly Newsletter – Volume 3, No. 7 – July 11, 2007

## **Safe Harbor 401(k) Plan May be Amended Mid-Year to Reflect Recent Law Changes**

IRS has announced that a safe harbor 401(k) can be amended mid-year to reflect recent law changes without impacting the safe harbor status of the plan. Specifically, the IRS stated that a safe harbor 401(k) plan can be amended mid-year to implement a qualified Roth contribution program or to make certain hardship withdrawal changes. (*Ann 2007-59, 2007-25 IRB*)

Internal Revenue Code § 402A provides that for tax years beginning after 2005, a 401(k) plan can include a provision that allows participants to elect to have all or part of their elective deferrals treated as Roth contributions. In addition, IRS issued Notice 2007-7, 2007-5 IRB 395, which liberalized the hardship rules applicable to 401(k) plans based on changes made by the 2006 Pension Protection Act (PPA).

IRS decided to issue the announcement when it became aware that plan sponsors were reluctant to amend their safe harbor 401(k) plans mid-year to take advantage of these law changes since the safe harbor notice provided to plan participants prior to the beginning of the plan year did not include information regarding these changes.

In the announcement, the IRS stated that amendments made to implement a qualified Roth contribution program or the more liberal hardship withdrawal provisions would not impact the plan's status as a safe harbor plan. In addition, the IRS requested comments by September 17, 2007 as to whether additional guidance is needed for mid-year changes to 401(k) safe harbor plans other than guidance that has already been issued and the provisions in the Treasury Regulations that allow a plan to be amended mid-year to become a safe harbor plan using nonelective contributions or amendments made mid-year to suspend or reduce safe harbor matching contributions.

## **IRS Eliminates Schedule P to Form 5500**

IRS in an effort to reduce the administrative burden imposed on employers, plans, their administrators and trustees and custodians has eliminated the need to file Schedule P with their annual Form 5500, Annual Report of Employee Benefit Plans. The elimination of the Schedule P is effective for 2006 and later plan years. For years in which the Schedule P is eliminated, the IRS will treat the plan's filing of the Form 5500 as the filing of the associated trust that is a part of the plan. Thus the IRS will not assess income taxes with respect to an employee benefit trust later than 3 years from the later of the date the Form 5500 was due or filed. However, the 3 year statute of limitations is extended to 6 years in any case in which the plan has been a party to an abusive tax avoidance transaction.



*Let us help you manage your benefits cost and risk.*

Monthly Newsletter – Volume 3, No. 7 – July 11, 2007

## **IRS Issues Ruling on Partial Plan Termination**

In Revenue Ruling 2007-43, the IRS ruled that a 20% or more reduction in the number of employees participating in the plan establishes a rebuttable presumption that a partial plan termination has occurred. (Rev. Rul. 2007-43, 2007-28 IRB)

### ***Background***

A tax qualified retirement plan must provide that upon partial termination the rights of the affected employees to their benefits must be nonforfeitable, i.e., 100 percent vested. Whether a partial termination has occurred is determined by the IRS based on all the facts and circumstances of the particular case. Because of the inherently fact specific nature of the rule, the IRS has issued several rulings over the years on this issue and the courts have further refined the facts and circumstances test.

In this Revenue Ruling the IRS has adopted the 20% presumption rule that was adopted by the Seventh Circuit in *Matz v. Household International Tax Reduction Investment Plan*, (2004, CA7) 388 F3d 570. Under this ruling if the turnover rate is at least 20%, there is a presumption that a partial termination of the plan has occurred. The turnover rate is determined by dividing (a) the number of participating employees who had an employer-initiated severance from employment during the applicable period by (b) the sum of all of the participating employees at the start of the applicable period and the employees who became participants during the applicable period. The ruling defines the applicable period as a plan year (or in the event that a plan year is less than 12 months, the plan year plus the immediately preceding plan year) or a longer period if there is a series of related severances from employment. In addition, all participating employees (both vested and nonvested) are taken into account in calculating the turnover rate.

The ruling also defines employer-initiated severance from employment as severance from employment other than severance that is on account of death, disability, or retirement on or after normal retirement age. The ruling also states that factors outside the employer's control, e.g., depressed economic conditions, can still be held to be an employer-initiated severance from employment. Factors that favor a finding of voluntary severance include information from personnel files, employee statements, and other corporate records.

Under the ruling, employees who are transferred to another controlled group are not considered as having a severance from employment for purposes of calculating the turnover rate if those employees continue to be covered by a plan that is a continuation of the plan under which they were previously covered.



*Let us help you manage your benefits cost and risk.*

Furthermore, the IRS stated that the 20% test is still a rebuttable presumption. For example, if the turnover rate is routine for the employer, then it favors a finding that a partial termination has not occurred. For this purpose, information as to the turnover rate in other periods and the extent to which terminated employees were actually replaced, whether the new employees performed the same functions, had the same job classification or title, and received comparable compensation are relevant to determining whether the turnover rate is routine for the employer.

IRS clarified that a partial termination of a plan can occur for reasons other than turnover. For example, a plan amendment that changes the eligible group of employees to exclude employees who were previously covered under the plan or a plan amendment that reduces or ceases future benefit accruals which results in a potential reversion to the employer.

### **IRS Issues Proposed Regulations on HSA Comparability Rules**

On June 1, 2007 the IRS released proposed regulations regarding Health Savings Accounts (HSAs). These proposed rules apply to two specific situations.

- ❖ When an employee has not established an HSA by December 31<sup>st</sup> or the employee did establish an HSA but failed to notify the employer and
- ❖ When an employer wishes to accelerate contributions to an HSA because the employee has incurred medical expenses in excess of the monies in the HSA.

#### ***Background***

HSAs are tax-exempt savings accounts funded by an individual or an employer for the purpose of paying qualified medical expenses. HSAs must be paired with high deductible health plans. Generally, an employer must make comparable contributions to the HSAs of all comparable participating employees. If the employer does not make comparable contributions it is subject to an excise tax of 35% of the aggregate amount that it contributed to the HSAs of its employees during the calendar year. If an employer permits employees to make pre-tax HSA contributions under a cafeteria plan, i.e., Section 125 plan, then the employer is not subject to the comparability rules.

#### ***Proposed Regulations***

The proposed regulations provide that in the case of an employee who has not established an HSA by December 31<sup>st</sup> or who had established an HSA but failed to let his/her employer know that the HSA had been established, the employer would meet the comparability rules for the calendar year if it does both of the following:



*Let us help you manage your benefits cost and risk.*

Monthly Newsletter – Volume 3, No. 7 – July 11, 2007

- ❖ The employer must provide a written notice that it will make comparable contributions for eligible employees who both establish an HSA and notify the employer that they have established an HSA by the last day of February of the following calendar year. The written notice must be provided no earlier than 90 days before the first HSA contribution and no later than January 15<sup>th</sup> of the following calendar year. The proposed regulations contain language that can be utilized by employers for the required written notice. And
- ❖ The employer makes comparable contributions plus reasonable interest to the HSA of each eligible employee who establishes an HSA and notifies the employer by the last day of February that it has been established. The contribution amount must take into account each month that the employee was a comparable participating employee.

In many instances, employers make contributions to an employee's HSA on a pay period basis. The proposed regulations provide that an employer can make accelerated contributions to an employee's HSA up to an annual limit if an employee incurs large medical expenses early in the year that exceed the funds in the HSA. These rules are similar to the rules that apply to Flexible Spending Accounts (FSAs) which require that employers make available on January 1<sup>st</sup> of the plan year the full amount that would be collected from employees through payroll deductions during the year. The one distinction to the pre-funding of HSA is that the employer is not required to make available the amounts that the employee would fund on a pay period basis. Therefore, the employer is only required to make available on January 1<sup>st</sup> the total amount the employer would contribute during the calendar year. Whether an employer makes early contributions to an employee's HSA is purely voluntary as long as all employees in similar situations are treated the same.

### *Effective Date*

The proposed regulations are to apply to employer HSA contributions made after the date the final regulations are published. In the interim an employer can rely on these proposed regulations or the 2005 proposed regulations that provided that an employer was not required to make comparable contributions for a calendar year to an employee's HSA if the employee had not established an HSA by December 31<sup>st</sup> of the calendar year.



*Let us help you manage your benefits cost and risk.*

## **Court Holds that Retiree Medical Benefits Can be Coordinated with Medicare**

The Third Circuit Court of Appeals recently held on June 4, 2007 that a proposed regulation issued by the Equal Employment Opportunity Commission (EEOC) did not violate the Age Discrimination in Employment Act (ADEA). (*AARP v. EEOC*<sup>1</sup>) The proposed regulation that was issued by the EEOC in 2003 created a narrow exemption to the ADEA which allows plan sponsors to reduce or terminate retiree medical benefits for Medicare-eligible retirees without regard to the coverage the employer provides to younger retirees. The recent decision by the court allows the EEOC to move forward with the final rule which provided for the limited exemption from the ADEA requirements.

### **Background**

In 2000 the Third Circuit Court of Appeals issued a controversial decision in *Erie County Retirees Association v. County of Erie*, 220 F.3d 193 (3<sup>rd</sup> Cir.2000). The *Erie County* decision held that Erie County could not reduce the health coverage options for retirees once they became Medicare-eligible. The court reasoned that the reduction in health options for Medicare-eligible retirees violated the ADEA because Medicare-eligible retirees are by definition age 65.

The EEOC adopted the court's decision in *Erie County* as its national enforcement policy. The EEOC learned through its enforcement efforts that the *Erie County* rule was having the unintended consequences of discouraging employers from providing any retiree medical benefits. Therefore, the EEOC took the matter under advisement and on July 23, 2003 it published a proposed rule for comment that would exempt from ADEA's discrimination provisions the coordination of retiree health benefit plans with Medicare-eligibility. The EEOC approved the final regulations in essentially the same form as the proposed regulations on April 22, 2004.

AARP filed suit on February 4, 2005 challenging EEOC's authority to grant the limited exemption. AARP argued that the exemption was illegal because it would allow employers to violate the ADEA by providing lesser health benefits to Medicare-eligible retirees. The EEOC countered this argument with the fact that the ADEA gives it broad authority to exempt employers from provisions in the ADEA, as long as the exemption is "reasonable" and "necessary and proper in the public interest." It was EEOC's position that the narrow exemption met these standards in that employers were more likely to eliminate coverage for early retirees rather than expand coverage for over-65 retirees.

---

<sup>1</sup> <http://www.ca3.uscourts.gov/opinarch/054594p.pdf>.



*Let us help you manage your benefits cost and risk.*

EEOC eventually won at the trial court level and AARP appealed the case to the Third Circuit.

In a unanimous ruling the Third Circuit agreed with the EEOC. The court concluded that the exemption is narrowly drawn, consistent with the authority granted the EEOC in the ADEA, and valid under the laws governing the issuance of agency regulations. Therefore, the EEOC has the right to issue the regulation in final form.

### ***Impact of Decision***

This decision provides employers with more flexibility in drafting retiree health programs and in coordinating those programs with Medicare, including the Medicare prescription drug benefit.

## **Court Rules that Plan Provision on Separated Spouses Does Not Violate ERISA or COBRA**

A recent decision by U.S. District Court for the Eastern District of Pennsylvania held that a Teamsters health and welfare plan did not have to provide coverage to a separated spouse. (*Falcone v. Teamsters Health and Welfare Fund*, 2007 U.S. LEXIS 39525 (E.D. Pa. 2007))

### ***Background***

Mary Falcone was the spouse of a covered participant in the Teamsters Health and Welfare Fund (the “Fund”). After she separated from her husband, she notified the Fund of her new address. The Fund notified her that she was no longer eligible for benefits under the Fund since she and her husband were living apart. Specifically, the Fund’s governing documents provided that a spouse could be covered only if “not separated (living separate and apart as defined by [state] law)” from the participant. Pennsylvania law defined “separate and apart” as “cessation of cohabitation.” The Fund terminated her coverage retroactively but offered her the option to elect COBRA coverage. She elected COBRA coverage but sued to challenge the Fund’s action, contending that the Fund was not permitted to terminate her coverage as a spouse until she had a final divorce decree.

The court ruled in favor of the Fund. First, the court noted that ERISA gives plan sponsors wide discretion to decide who should be eligible for coverage under its health and welfare plans. The court stated that there is nothing in ERISA which prevents an employer-provided health and welfare fund from terminating a beneficiary spouse before the spouse is divorced. Additionally, there is nothing in ERISA which mandates that a



*Let us help you manage your benefits cost and risk.*

Monthly Newsletter – Volume 3, No. 7 – July 11, 2007

health and welfare plan even provide spousal coverage. The court stated that Congress's failure to mandate spousal coverage in health and welfare plans when it has provided for spousal benefits in other parts of ERISA represents a deliberate policy to leave this issue to the discretion of individual plan sponsors. Therefore, the Fund did not violate ERISA by terminating Ms. Falcone's coverage.

With respect to Ms. Falcone's second claim that her coverage should not have been terminated until she experienced a qualifying event under COBRA, the court found that it would contravene the flexibility available in plan design if her coverage could only be terminated in situations involving COBRA qualifying events. The court therefore entered judgment for the Fund.

## **DOL Publishes Comments on FMLA**

In connection with the U.S. Department of Labor's Employment Standards Administration (ESA) regulations under the Family and Medical Leave Act of 1993 (FMLA), ESA requested information from the public regarding their experiences with FMLA and comments on the effectiveness of the current regulations. ESA received more than 15,000 comments. ESA has issued a report on FMLA based on the comments that it received.

### ***Background***

FMLA provides workers with basic rights to job protection for absences due to the birth or adoption of a child or for a serious health condition of the worker or a family member. Under FMLA the employer is required to maintain for the employee any preexisting group health coverage during the leave period, and that once the leave period has concluded, reinstate the employee to the same or an equivalent job with equivalent benefits, pay, and other terms and conditions of employment. The law generally covers employers with 50 or more employees and employees must have worked for the employer for 12 months and have 1,250 hours of service during the previous year to be eligible for coverage.

The report is divided into the following chapters:

- ❖ Chapter I, Employee Perspectives: Experiences in the Value of FMLA;
- ❖ Chapter II, Ragsdale Decision/Penalties;
- ❖ Chapter III, Serious Health Condition;
- ❖ Chapter IV, Unscheduled Intermittent Leave;
- ❖ Chapter V, Notice: Employee Rights and Responsibilities;
- ❖ Chapter VI, The Medical Certification and Verification Process;



*Let us help you manage your benefits cost and risk.*

- ❖ Chapter VII, Interplay between the FMLA and the Americans with Disabilities Act;
- ❖ Chapter VIII, Transfer to an Alternative Position;
- ❖ Chapter IX, Substitution of Paid Leave;
- ❖ Chapter X, Joint Employment; and
- ❖ Chapter XI, Data: FMLA Coverage, Usage, and Economic Impact

The report concludes that FMLA is working as intended and is very successful with respect to the provisions dealing with leave related to the birth or adoption of a child and leave associated with serious health conditions that require blocks of leave. However, the report concludes that FMLA leave has continued to increase in unanticipated ways, primarily in the area of intermittent leave taken as self-treatment for chronic serious health conditions, there are significant concerns.

The report was published in the Federal Register on June 28, 2007 and can be accessed at <http://www.dol.gov/esa/whd/FMLA2007FederalRegisterNotice/07-3102.pdf>.