

SMITH & DOWNEY
CLIENTS & FRIENDS SEMINAR - MAY 5, 2010

[Note that this Outline is only a very general discussion of some issues in the law, and is not intended as legal advice for any particular situation.]

HEALTH AND WELFARE PLANS

I. HEALTH CARE COVERAGE REFORM LEGISLATION

A. Overview. The recently enacted health care reform law actually is the combination of the Patient Protection and Affordable Care Act enacted on March 23, 2010 and the Health Care and Education Reconciliation Act enacted on March 30, 2010.

The law continues the current American system of the provision of health care coverage through a combination of governmental programs (Medicare, Medicaid, Tricare, etc.), for-profit health insurance, and self-funded employer-provided plans. That is, the involvement of employers in the provision of health care coverage is maintained, and in fact is mandated beginning in 2014.

The one structural change included in the law is the concept of mandating that American citizens and lawful residents begin paying into the health care coverage system in 2014.

Note that the law generally applies to all employer health plans, whether insured, self-funded, large, small, governmental, for-profit or non-profit. Note also that many provisions of the law will require regulatory clarification before they can be fully understood and implemented.

B. The Two Sets of Rules. The law contains a rather extensive set of new rules for "new" health plans, and a more limited set of rules for "grandfathered" health plans. Grandfathered health plans are those in existence on March 23, 2010. Unfortunately, there is no guidance in the statute about what could cause a grandfathered plan to lose its grandfathered status, so employers should monitor developments in this area very carefully.

C. Tasks for Employers. Employers should: 1. review the employer-related provisions of the law; 2. identify their grandfathered and non-grandfathered health plans; 3. consider carefully any contemplated post-March 23, 2010 changes that might cause a loss of grandfathering; 4. create a compliance deadline calendar and "to do list" that anticipates the applicable changes; 5. consult with their advisors about the various strategic "big picture" decisions that must be made as a result of the law (e.g., whether to "pay" or "play" beginning in 2014); and 5. carefully monitor regulatory and other developments.

D. Chronological Listing of Changes Directed at Employers.

1. June 23, 2010 – New free federal re-insurance plan for self-funded early retiree plans opens and continues until \$5B in funding is utilized.

2. First Plan Year Beginning After September 22, 2010 Changes:

a. Eliminate any lifetime coverage maximums on essential benefits.

b. Eliminate any annual coverage maximums on essential benefits. (Grandfathered, insured, non-ERISA plans may continue annual maximums until 2014. Note that there is ambiguity about this rule that will require clarification.)

c. Eliminate any rescission provisions (except for fraud or misrepresentation).

d. Eliminate pre-ex limitations for children under age 19.

e. Provide for coverage for children until age 26. (Grandfathered plans need not provide if other employer-based coverage available.)

- f. Eliminate cost-sharing for preventive care. (Not applicable to grandfathered plans.)
- g. Apply new nondiscrimination rules to insured coverages (similar, but not identical, to Code Section 105(h) rules). (Not applicable to grandfathered plans.)
- h. Permit selection of any primary care provider. (Not applicable to grandfathered plans.)
- i. Permit children to select pediatrician as primary care provider. (Not applicable to grandfathered plans.)
- j. No pre-authorization required for emergency care. (Not applicable to grandfathered plans.)
- k. No pre-authorization or referral required for ob-gyn care. (Not applicable to grandfathered plans.)
- l. Provide required internal and external appeals mechanisms. (Not applicable to grandfathered plans.)
- m. "Simple" Section 125 plans available to employers with fewer than 100 employees.
- n. "Qualified Small Employers" (e.g., generally, fewer than 26 FTEs with average wages of \$50,000 or less) eligible for health plan tax credit.

3. 2011 Changes:

- a. OTC drugs not reimbursable from HFSA's, HRAs and HSAs unless per a prescription.
- b. Optional CLASS long term care program may be offered or auto enrolled by employers.

4. 2012 Changes:

- a. 2011 W2s issued by January 31, 2012 must include value of employer health plan coverage.
- b. By March 23, 2012, issue to employees new "Uniform Explanation of Coverage" in the form specified in HHS regulations and sample.
- c. Beginning March 23, 2012, satisfy requirement of 60 days' advance written notice to participants of health plan "material changes".
- d. For plan years beginning after September 30, 2012, pay the required federal fee of \$1 times average number of covered lives (for "Patient-Centered Outcomes Research Trust Fund").

4. 2013 Changes:

- a. \$2500 cap on HFSA's.
- b. Employee Medicare tax increases to 2.35% for Medicare wages over \$250,000 joint/\$200,000 separate.
- c. Cease employer deduction for Part D retiree coverage subsidy.
- d. Patient-Centered Outcomes Research Trust Fund fee increases from \$1 to \$2 times average number of covered lives.
- e. Comply with HHS regulations on required annual reports to HHS and employees on health plan benefits that "improve health".
- f. Provide employees with HHS information notices about 2014 exchanges and subsidies.

5. 2014 Changes:

- a. Provide Employee Free Choice Vouchers to eligible employees.
- b. Eliminate waiting periods over 90 days.
- c. Eliminate all pre-ex limitations.
- d. Report minimum essential coverage information to employees and regulators (per regulations to be issued).
- e. Provide coverage for "routine costs" incurred in connection with clinical trials. (Not applicable to grandfathered plans.)
- f. Cease "discrimination" against licensed providers. (Not applicable to grandfathered plans.)
- g. Ensure that out-of-pocket exposure is no higher than is permitted for HDHPs. (Not applicable to grandfathered plans.)
- h. Ensure that deductibles are no higher than \$2,000 for self-only coverage and \$4,000 for other coverages. (Not applicable to grandfathered plans.)
- i. Qualifying wellness program penalties/rewards may be raised from 20% to 30% of cost (and perhaps as high as 50% if permitted by the regulators).
- j. If 200 or more FTEs, auto enroll employees in health plan.
- k. Continue to provide required notices concerning exchanges and subsidies.
- l. Decide whether to participate through the exchanges, and whether to permit salary reduction contributions for exchange-based coverage. (Exchanges only open in 2014 for employers with fewer than 50 employees.)
- m. Play, or pay, under play-or-pay rules.
- n. If applicable, pay under play-and-pay rules.
- o. Grandfathered, insured, non-ERISA plans must remove annual maximums on essential benefits. (Note that there is ambiguity about this rule that requires clarification.)
- p. Grandfathered plans must begin coverage for children until age 26 even if other employment-based coverage is available.

6. 2016 Change: Exchanges begin to operate for employers with up to 100 employees.

7. 2017 Change: Exchanges may begin to operate for all employers.

8. 2018 Change: Excise tax on "Cadillac Plans" equal to 40% of excess value over the limit of \$27,500 family, \$10,200 self-only (as adjusted).

9. 2020 Change: Patient-Centered Outcomes Research Trust Fund fee no longer applicable.

II. HITECH ACT UPDATE

A. Overview. The Health Information Technology for Economic and Clinical Health Act (the HITECH Act) was enacted in February 2009 as part of the American Recovery and Reinvestment Act (ARRA). The HITECH Act made a number of changes to the HIPAA privacy and security requirements that apply to health plans and other "covered entities". Most requirements of the HITECH Act became effective February 17, 2010 but some provisions became

effective earlier (including the breach notice requirements, as described below) while others will not become effective until regulations or other guidance is provided. In addition to implementing the new requirements, health plans and business associates will need to review and update HIPAA privacy notices, business associate agreements and HIPAA privacy and security policies and procedures documents to comply with the Act.

B. Business Associates. For the first time, business associates are now directly subject to most of the HIPAA privacy and security requirements (rather than simply contractually subject through their business associate agreements with their clients).

C. Business Associate Agreements. Business associate agreements must incorporate the new privacy and security requirements of the HITECH Act, including details about the breach notification requirements (described below) and, if applicable, the expanded participant rights (also described below). Other changes are required to reflect the fact that business associates will be directly subject to the regulations.

D. Minimum Necessary Standard. Under current law, the rather vague “minimum necessary” standard applies to most uses or disclosures of PHI (with certain exceptions, which relate mostly to uses or disclosures for treatment purposes). The Act requires HHS (by August 2010) to issue regulations to flesh out this standard. Until that guidance is issued, if practical, for all uses and disclosures that are subject to the minimum necessary standard, only a “limited data set” should be used or disclosed. A limited data set is PHI from which most identifying information has been removed. If use or disclosure of the limited data set is not practical, the more general minimum necessary standard still applies.

E. Participant Rights. If a covered entity maintains information in the form of an Electronic Health Record, there are new specific participant rights with respect to requesting an accounting of PHI disclosures or requesting access to the EHR. An EHR is an electronic record of health-related information on an individual that is created, gathered, managed, and consulted by authorized health care clinicians and staff. EHRs generally are more likely to be maintained by providers than by health plans, so this feature of the HITECH Act is more likely to apply to health care providers.

Also, covered entities are now required to comply with a request for restrictions on disclosures of an individual’s PHI to a health plan, if the PHI is limited to information about services for which the provider has been paid in full out of pocket. This is a new exception to the general principle that covered entities are required to consider requests for restrictions but are not required to agree to them. (This requirement also is much more likely to affect providers than health plans).

F. Penalties and Enforcement. Potential penalties for HIPAA violations have increased to as much as \$50,000 per violation up to a total of \$1.5 million for all violations of a single requirement for the year. There is a new 4-tier structure for penalties, so that the minimum penalty amount increases based on the degree of knowledge or intent and whether the violation has been corrected. HHS’ enforcement activity also is to be increased, with more audits, etc. The Act also provides that a State Attorney General can now bring a federal civil action to enforce HIPAA privacy and security requirements.

Also, effective February 17, 2011, HHS will be required to impose penalties for certain violations if the failure to comply is due to willful neglect, such as if a covered entity fails to maintain a written HIPAA privacy or security policies and procedures document or fails to train its workforce with access to PHI on HIPAA’s requirements. (Currently, HHS has discretion about whether to impose penalties and imposes them relatively rarely.)

G. Breach Reporting Requirements. The HITECH breach regulations provide requirements for reporting a “breach” of “unsecured PHI”. The breach notification requirements became effective for breaches discovered on or after September 23, 2009.

Generally, under the regulations, “unsecured PHI” is any PHI, including all paper documents that include PHI, that is not protected by a technology that has been determined by HHS to render the information “unusable, unreadable, or indecipherable to unauthorized individuals.” Currently, the only type of technology that will make PHI “secured” for this purpose is encryption in accordance with certain technical requirements. So, all unencrypted PHI is considered unsecured PHI.

A breach of unsecured PHI occurs if unsecured PHI is acquired, used or disclosed in a manner that is not permitted under the regulations and that “poses a significant risk of financial, reputational, or other harm to the individual.”

Reporting requirements for health plans. Generally, upon discovery of a breach, a health plan is required to notify each individual whose PHI is reasonably believed to have been affected. The notice must be provided without unreasonable delay and in no case later than 60 days after discovery. A breach is treated as being discovered on the first day it is known (or would have been known, if the covered entity had exercised due diligence) by the plan.

In addition to notice to individuals, notice to HHS is required. If the breach involves 500 or more individuals, this notice must be provided within the same time limits that apply to notice to individuals. If fewer than 500 individuals are involved, notice to HHS must be provided, along with notice of all other breaches for the same calendar year, in a report that must be filed no later than 60 days after the end of the calendar year. Procedures for the HHS notice requirements will be provided through an HHS website.

If the breach involves more than 500 residents of the same State or other jurisdiction, notice to “prominent media outlets” serving the area must be provided. The notice must satisfy the same content requirements that apply to the notice to individuals and must be provided by the same deadline.

Reporting requirements for business associates. Upon discovery of a breach, a business associate must provide information about the breach to the applicable health plan or other covered entity, without unreasonable delay and in no case later than 60 days after discovery.

III. ELECTRONIC DELIVERY RULES

Federal law imposes a number of participant notification and communication requirements on sponsors of employee benefit plans. Many, but not all, of these requirements can be satisfied by providing documents in an electronic format if certain specific requirements are met. The requirements for electronic delivery vary depending on the source of the particular notice requirement. That is, different requirements are imposed by the IRS, the DOL, the Department of Health and Human Services, the Centers for Medicare and Medicaid Services, etc. The following discusses some of the most important of these electronic delivery requirements.

A. Electronic Delivery of Documents Required by ERISA

Department of Labor regulations govern electronic delivery of all notices or other participant communications required by Title I of ERISA (e.g., SPDs, Summary Annual Reports, COBRA notices, Participant Benefit Statements, requested plan documents, requested copies of Form 5500 annual reports, etc.). Employers who wish to use electronic delivery methods to satisfy the distribution requirements for these documents must comply with the following requirements (which, for most employers, are difficult to meet with, at least for 100% of their employees):

1. The employer must take appropriate and necessary measures reasonably calculated to ensure that the system for furnishing the documents electronically: a. results in actual receipt by participants of electronically transmitted information and documents (e.g., using return-receipt or notice of undelivered electronic mail features, conducting periodic reviews or surveys to confirm receipt of the transmitted information, etc.); and b. protects the confidentiality of personal information relating to the individual’s accounts and benefits (e.g., incorporating into the system measures designed to preclude unauthorized receipt of or access to information by individuals other than the individual for whom the information is intended, etc.).
2. Electronically delivered documents must be consistent with the style, format and content requirements applicable to the particular document being delivered.
3. Notice is provided to each recipient at the time a document is furnished electronically, that informs the recipient of the significance of the document and of the participant’s right to request and obtain a paper version of the document.
4. Upon request, a paper version of the electronically furnished documents is provided.
5. Electronic delivery may be used for recipients who: a. have the ability to effectively access documents furnished in electronic form at the location where the recipient performs his or her duties; and b. with respect to whom access to the employer’s electronic information system is “an integral part” of those duties.

6. For any recipient not described in 5 above, electronic delivery may be used only if:

a. The recipient has affirmatively consented, in a manner that reasonably demonstrates an ability to access information in the electronic format that will be used to provide the information that is the subject of the consent, and has provided addresses for receiving the electronically furnished documents; and

b. Before consenting, the recipient has received, a clear and conspicuous statement indicating: (1) the types of documents to which the consent would apply; (2) that consent can be withdrawn at any time without charge; (3) the procedures for withdrawing consent and for updating the individual's address for receipt of electronically furnished documents; (4) the recipient has the right to request and obtain a paper version of an electronically furnished document, including whether the paper version will be provided free of charge; and (5) any hardware and software requirements for accessing and retaining the documents; and

c. Following consent, if a change in hardware or software requirements needed to access or retain electronic documents creates a material risk that the individual will be unable to access or retain electronically furnished documents, then the individual must: (1) be provided with a statement of the revised hardware or software requirements for access to and retention of electronically furnished documents; (2) be given the right to withdraw consent without charge and without the imposition of any condition or consequence that was not disclosed at the time of the initial consent; and (3) again consent, as provided above.

B. Electronic Delivery of Documents Required by the Internal Revenue Code

IRS regulations provide the electronic delivery requirements for notices, elections and consents and other documents that are required to be provided to or received from a recipient in writing based on a provision of the Internal Revenue Code regarding retirement plans, health and accident plans, cafeteria plans, qualified transportation fringe benefit programs, educational assistance programs, Archer MSAs and health savings accounts. These rules do not apply to any document required under Title I or Title IV of ERISA for which the Department of Labor (or the PBGC) has interpretative and enforcement authority. The procedures described in the regulations also may be used as a safe harbor form of delivery for any notice required under the Code (with respect to any of the benefits described above) that is not required to be in writing.

These rules apply, for example, to 402(f) notices (eligible rollover distribution notices), 204(h) notices, Qualified Joint and Survivor Annuity and Qualified Preretirement Survivor Annuity notices, 401(k) safe harbor plan notices, notices of available distribution options and notices to interested parties.

Any required notice is treated as being provided in writing if the following requirements are satisfied:

1. The notice must be provided in a format that is reasonably designed to provide the information in a form that is no less understandable to the recipient than a written paper document.

2. The electronic system must be designed to alert the recipient of the significance of the notice, including identifying the subject matter of the notice and to provide readily understandable instructions for accessing the notice.

3. Affirmative consent to receive notices electronically is not required if the following requirements are met: a. The recipient has the effective ability to access the electronic medium used to provide the notice; and b. At the time the notice is provided, the recipient is advised that he or she may request and receive the notice in writing on paper at no charge.

4. For any recipient not described in 3 above, electronic delivery may be used only if:

a. Consent for electronic delivery is provided by one of the following methods: (1) electronic consent provided in a manner that reasonably demonstrates that the recipient can access the notice in the electronic format used to provide the notice; or (2) written consent on a paper document, but only if the recipient confirms the consent electronically in a manner that reasonably demonstrates that the recipient can access the notice in the electronic format used to provide the notice; and

b. Before consenting, the recipient must receive a clear and conspicuous statement that describes: (1) the recipient's right to receive a paper notice, including the right to receive such a paper copy after consenting to electronic delivery (and whether a fee would be charged in case of a post-consent request); (2) the recipient's right to withdraw consent to receiving the notice in electronic format, and the methods and any consequences of withdrawing consent; (3) the scope of the consent, e.g., whether the consent applies to the current transaction only or to all future notices; (4) the procedures for updating the recipient's email address or other electronic contact information; and (5) the hardware and software requirements that apply for purposes of accessing and retaining the electronic notice; and

c. Following consent, if there are changes in hardware or software that create a material risk that the recipient may no longer be able to access or maintain electronic notices, a statement describing the new requirements must be provided, along with a statement of the recipient's right to withdraw consent to electronic delivery. The recipient must then reaffirm his or her consent to electronic delivery.

5. Requirements for Participant Elections. For a participant election made in electronic form to be valid, the requirements described above must be satisfied, along with the following additional rules: a. the participant must be effectively able to access the electronic medium used to make the election; b. the electronic system used for participant elections must be reasonably designed to preclude any person other than the appropriate individual from making the election; c. the electronic system must provide the person making the participant election a reasonable opportunity to review, confirm, modify, or rescind the election before the election becomes effective; d. the person making the participant election must receive, within a reasonable time, a confirmation of the effect of the election under the terms of the plan or arrangement through either a written paper document or an electronic medium (that meets the electronic notice requirements described above); e. for any participant elections, including spousal consents, that are required to be witnessed by a plan representative or a notary public, the election and signature can be made electronically, but note that the signature of the individual making the participant election still must be witnessed in the physical presence of a plan representative or a notary public.

C. Electronic Delivery of HIPAA Privacy Notices

A group health plan may satisfy the HIPAA privacy notice distribution requirements by providing an electronic notice only if the electronic delivery satisfies the requirements of regulations issued by the Department of Health and Human Services.

Under the HIPAA privacy regulations, a health plan may provide the notice by e-mail to any person who has affirmatively consented to receiving the notice by email and has not withdrawn that consent. If the plan knows that the e-mail was not received, it must provide a paper copy. A paper copy also must be provided if requested by an individual, whether that individual has consented to electronic delivery or not.

In addition, note that the regulations require that an electronic copy of the notice be available for download on any website or intranet site that provides information about employee benefits to employees.

IV. ERISA COVERAGE OF VOLUNTARY BENEFITS

A. Background. Under ERISA, the term "employee welfare benefit plan" includes plans providing medical, surgical or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeships or other training programs, or day care centers, scholarship funds, or prepaid legal services, or plans which provide holiday or severance benefits. DOL regulations prescribe a number of arrangements which are not considered employee welfare benefit plans subject to ERISA, including certain voluntary group or group-type insurance programs.

B. Voluntary Benefits Exception. Group or group-type insurance programs are not treated as employee benefit plans for purposes of ERISA if, under the terms of the program 1) no contributions are made by the employer; 2) participation in the program is completely voluntary for employees; 3) the sole function of the employer with respect to the program is without endorsing the program, to permit the insurer to publicize the arrangement to employees and to collect premiums from employees through payroll deductions and remit them to the insurer; and 4) the employer receives no consideration in connection with the program except reasonable expenses.

C. Employer Involvement. The absence of employer involvement or “endorsement” is key to the rationale for not treating group programs as ERISA employee welfare benefit plans. DOL guidance states that endorsement occurs if the employer urges or encourages participation in the program or engages in activities that would lead employees to reasonably conclude that the program is part of a benefit arrangement established or maintained by the employer. The employer may facilitate the marketing of a program, but only to the extent short of endorsing the program. Actions that courts and/or the DOL have determined to indicate “endorsement” or employer involvement exceeding the bounds of the group insurance exception are:

1. Taking some position or action on behalf of or in coordination with the insurer, such as making suggestions or negotiating with the insurer as to plan design and structure of the program.
2. Representing the plan to employees as part of its benefit package, such as incorporating the terms of the insurance program into a SPD or characterizing the program as an employer program in a brochure.
3. Providing help to employees in understanding their rights in filing claims under the plan.
4. Deciding key contract terms (such as amount of coverage), or deciding issues of employee eligibility.
5. Creating a contract with the insurance company and designating employees who were to be eligible to purchase coverage.

V. REQUIRED AMENDMENTS AND NEW NOTICE REQUIREMENTS

A. New Cafeteria Plan Regulations. Plans should already have been amended for these regulations, particularly any optional features made available for the first time in the regulations that the Plan has adopted (such as qualified reservist distributions.) If the Plan adopts any of the new options going forward, the Plan must be amended in advance. For example, if a Plan decides to implement the dependent care spend down beginning January 1, 2011, the Plan must be amended by December 31, 2010.

B. ARRA (American Recovery and Reinvestment Act of 2009). While amendments to Plans to acknowledge the COBRA subsidies established under ARRA are certainly recommended, compliance in operation is key. As long as the COBRA subsidy lasts, COBRA subsidy qualifying event notices must be used instead of the Plan’s standard qualifying event notices. That means Plan sponsors, or the companies to whom they have delegated COBRA responsibilities, must keep current on extensions to the subsidy program. Recently, Congress passed an extension until May 31, 2010. That means the special COBRA subsidy qualifying event notice must be used for all COBRA qualifying events between September 1, 2008 and May 31, 2010. Additional extensions would surprise no one.

C. CHIPRA (Children’s Health Insurance Reauthorization Act of 2009). This Act was effective April 1, 2009, regardless of the Plan year. That means Plans already should have been amended for the Act and already should have been using revised special enrollment rights notices for over a year. We do have an update on the other notices required under CHIPRA.

All plans that provide coverage to an employee or beneficiary who is eligible for Medicaid or CHIP coverage are required, upon request, to provide information about benefits to State agencies that administer Medicaid and CHIP plans that is sufficient for such agencies to determine if it is cost-effective for an eligible employee or dependent to be enrolled in an employer’s plan (with premium assistance from the State) instead of receiving benefits from the Medicaid or CHIP program. The Department of Labor and the Department of Health and Human Services are supposed to develop a model “coverage coordination disclosure form” for use in providing this information. This model form must be used for requests made in plan years that begin after the model form has been issued. (It is not clear if plans are required to provide information to these State agencies upon request before the model form is provided, but the safest approach is to cooperate with reasonable requests.)

Also, most health plan sponsors are required to provide to each employee an annual written notice of currently available “potential opportunities”, if any, in the State in which the employee resides for premium assistance for health coverage for the employee and eligible dependents under the employer’s plans. A model notice for this purpose was published earlier this year. This notice is expected to be updated annually and should be available each year through a Department

of Labor website (currently at <http://www.dol.gov/ebsa/chipmodelnotice.doc>).

This notice requirement applies to all health plans that provide benefits to any participant or dependent who resides in any State that has implemented a Medicaid or CHIP program to provide for premium assistance under employer plans or that reimburses any provider in any of those States. Currently, forty States have such programs. The following States, and the District of Columbia, currently do not have such a program: Connecticut, Delaware, Hawaii, Illinois, Maryland, Michigan, Mississippi, Ohio, South Dakota and Tennessee, so employers whose plans do not cover any individuals or reimburse any providers in any of the other 40 States are not currently subject to the notice requirement.

For employers that are subject to the notice requirement, the notice must be provided at least once each year to “all employees” (including employees who are not eligible for health coverage) who reside in one of the States that has implemented a Medicaid or CHIP program to provide for premium assistance under employer plans.

If desired, the notice can be revised to eliminate the contact information for States in which no employee resides. The notice is three pages long, so editing it can be useful. Also, there is no harm in providing the notice to all employees if that is simpler than trying to identify only those employees who live in one of the forty states described on the model notice.

The first notice must be provided no later than the later of May 1, 2010 or the first day of the first Plan year that begins after February 4, 2010 (January 1, 2011 for calendar year plans). Failure to comply with the notice and reporting requirements subjects an employer to fines of up to \$100 per day for each employee or beneficiary affected by the failure.

D. Michele’s Law. Many Plans that define “dependent” by reference to student status already should have been amended for Michele’s Law since it was effective for the first Plan year beginning on or after October 9, 2009. Essentially, the law requires that a dependent child who is covered as a full-time student be permitted to continue coverage for up to one year if he or she loses eligibility due to a change in student status resulting from a medically necessary leave of absence from school.

E. USERRA Rights Poster. Employers are required to post a notice of employees' rights under the Uniformed Services Employment and Re-employment Act. This notice can either be posted wherever other required workplace notices are posted or a copy of the notice can be provided to each employee who goes on military leave. The notice is available online at: www.dol.gov/vets/programs/userra/poster.htm.

F. Mental Health Parity (the Paul Wellstone and Pete Domenici Mental Health Parity and Addiction Equity Act of 2008). This Act was effective for the first Plan year beginning on or after October 3, 2009. The provisions of the Act primarily impact the provisions of the Schedule of Benefits. However, we recommend all Plans be amended to acknowledge compliance with the Act (this is particularly important for self-funded plans).

G. GINA (the Genetic Information Nondiscrimination Act of 2008). This Act is generally effective for the first Plan year beginning on or after May 21, 2009. We recommend that Plans be amended to evidence compliance and that the Plan’s Privacy Notice be updated to recognize GINA as well.

VI. 2009 FORM 5500 CHANGES (WELFARE PLANS AND RETIREMENT PLANS)

A. Forms Affected. These changes affect 5500 forms filed for plan years beginning January 1, 2009 or later.

B. Certain Schedules No Longer Required. These schedules are no longer required (1) Schedule E (applies to employee stock ownership plans only), (2) Schedule SSA (has been replaced by Form SSA to be filed directly with the IRS – on paper for 2009 and 2010 plan years - electronically by 2011) and (3) Schedule B which has been replaced by Schedules SB and MB (these are forms that apply to defined benefit and certain money purchase pension plans).

C. Revisions to Form 5500 Itself. These include: (1) new pension plan characteristics codes (for automatic enrollment and default investment features), (2) removal of pension plan characteristic code 3E (plans that previously used 3E should now use 3D), (3) question on number of contributing employers (applies to multiemployer (union) plans only), (4) removal of optional line for principal preparer, and (5) removal of the limited financial reporting exemption for Code Section 403(b) plans (tax sheltered annuity plans).

C. Schedules Revised.

Schedule A has been revised to provide for identification of insurers that fail to supply information and to break out commission information previously reported on line 2 onto lines 2 and 3. The instructions say that the plan administrator (typically the plan sponsor) should notify the insurer that the plan administrator intends to identify the insurer on Schedule A as not having provided the necessary information. Just one example of why preparing Form 5500s requires a much longer lead time this year. The changes to the Schedule C are another example as are the mandatory electronic filing requirements (both discussed below).

Schedule C has been extensively revised. The instructions specifically provide that any welfare plan that does have to file a Schedule H does not have to file a Schedule C so many welfare plans will not have to file a Schedule C. (No small plans – under 100 lives – have to file a Schedule C.) All service providers receiving \$5,000 or more must be reported, not just the top 40. In addition, fiduciaries and “Enumerated Service Providers” receiving more than \$1,000 in indirect fees also must be listed. Enumerated service providers provide one or more of the following services: contract administration, securities brokerage (stock, bonds, commodities), insurance brokerage or agency, custodial, consulting, investment advisory (plan or participants), investment or money management, recordkeeping, trustee, appraisal, or investment evaluation. There is a new, larger list of service codes. Fees are broken down into three categories: direct, indirect and eligible indirect. Direct fees are fees paid by the plan or plan sponsor. Indirect fees are compensation received from other sources. “Bundled service arrangements” fees must be broken down into the different types of compensation and reported separately. Service providers must disclose the formulas used for determining the compensation to the plan sponsor. The form has a new section to disclose non-cooperative service providers. One glitch in the system: the regulations that required service providers to provide fee information were withdrawn. Requesting information as soon as possible is recommended.

Schedule H (asset information for large plans) has been revised to disclose failures to pay benefits due, a schedule of delinquent participant contributions, questions on blackout compliance, and reporting of mutual fund dividends.

Schedule I (asset information for small plans) has been revised to disclose failures to pay benefits due, questions on blackout compliance, and separate disclosure of fees paid to administrative service providers.

Schedule R has been revised to add a new section called Summary of Funding Improvement Plan. The new section applies only to certain multiemployer (union) retirement plans. In addition, Schedule R has been revised to add questions about ESOPs (to replace the former Schedule E), add questions on asset allocations for large defined benefit plans and a new minimum funding question, and delete question 9 (minimum coverage).

D. Extensions of Time to File. Extensions are filed on Form 5558. For the 2008 forms, the IRS changed its procedures to not require a signature on this form when used to extend a 5500 filing deadline. In addition, the IRS stopped sending acknowledgements of extension requests. In January 2009, the IRS resumed sending acknowledgement letters to some plans. Those acknowledgements stated that the acknowledgement letter should be attached to the return when filed. The IRS has acknowledged that was a mistake and beginning 1/1/10, neither the completed 5558 nor the acknowledgement letter is required to be (or can be) filed with the Form 5500 under the electronic filing system.

E. New Form 5500-SF. Owner only plans may file this new form if eligible OR continue to file Form 5500-EZ but may not file on a Form 5500.

F. Mandatory Electronic Filing. ALL 2009 Form 5500 filings must be done electronically under the EFAST2 filing system. See www.efast.dol.gov. Filings will be screened and rejected immediately if incomplete (no more filing forms without an audit, for example). Accountant’s opinions and attachments must also be filed electronically as well (either in PDF or plain text format; accountant’s opinions must be in PDF format and must have a “wet” signature). Plan sponsors must electronically sign their own forms. Signing cannot be delegated to the preparer of the form. That will add to the lead time needed to get forms in on time.

Plan sponsors have 3 options for entering data and filing electronically: (1) a private web-based system; (2) a third party software application, which then transmits the form to the DOL via the internet; or (3) the DOL’s web-based system (IFILE). The DOL designed its system for companies that complete 2 or 3 5500s.

Filings will be publicly available on the DOL's website within 90 days. For amended filings, only the most recent filing will be shown.

QUALIFIED RETIREMENT PLANS

I. 403(B) ISSUES UPDATE

A. Plan Document.

403(b) plans are required to have written plan documents which comply with the regulations effective January 1, 2009. In Notice 2009-3, the IRS provided an extension for most plans to adopt their plan documents by December 31, 2009. The plan documents must be effective back to January 1, 2009 and the plan must have operated in accordance with the regulations during 2009.

In Announcement 2009-34, the IRS announced that it will open a pre-approval program for prototype 403(b) plans. Although the program has not yet been opened, in informal conversations with the IRS, we have been informed that it should be opening in the near future. Once the prototype opinion letter program opens, it is the intent to open a determination letter program so that individually designed 403(b) plans can receive determination letters.

B. Plan Audits.

Effective for plan years beginning on or after January 1, 2009, the annual reporting requirements changed for 403(b) plans that are subject to ERISA. Under the new requirements, ERISA-covered 403(b) plans can no longer use the special limited reporting used in the past. 403(b) plans with 100 or more participants are also required to file a plan audit with their Form 5500.

The audit requirement has been difficult for some employers due to the historical treatment of 403(b) plans. There is no specific rule on how far back the auditor needs to audit the plan. It appears that most auditors are going back at least two years.

1. FAB 2009-02.

The Department of Labor has issued some relief for the auditing requirement. In Field Assistance Bulletin 2009-02, the Department of Labor provided that annuity contracts and custodial accounts do not need to be treated as part of the plan for audit purposes if the following are true:

- a. The contract or account was issued to a current or former employee before January 1, 2009;
- b. The employer ceased to have any obligation to make contributions (including employee salary reduction contributions), and in fact ceased making contributions to the contract or account before January 1, 2009;
- c. All of the rights and benefits under the contract or account are legally enforceable against the insurer or custodian by the individual owner of the contract or account without any involvement by the employer; and
- d. The individual owner of the contract is fully vested.

The Department of Labor also acknowledged that there may be instances in which full compliance with the audit requirements may not be possible for the 2009 plan year. In the FAB, the Department of Labor stated that "the guiding principle must be to ensure that appropriate efforts are made to act reasonably, prudently and in the interest of the plan's participants and beneficiaries."

2. FAB 2010-01.

The Department of Labor issued Field Assistance Bulletin 2010-01 in February which discussed the audit requirements in a question and answer format. The FAB flushed out the requirements to qualify for the exemption from the audit requirement set out in FAB 2009-02, including the fact that the exemption from the audit requirement for contracts and

accounts that qualify extends beyond the 2009 plan year.

FAB 2010-01 also discussed what constitutes a “good faith” effort by the plan administrator to comply with the audit requirements. If the plan cannot fully comply with the audit requirements, the administrator has the burden of demonstrating that good faith was used and should document their efforts to comply. Good faith also requires the plan administrator to show that there are internal controls to keep and maintain records on an ongoing basis.

C. Exemption from ERISA.

Department of Labor regulation section 2510.3-2(f) sets out the requirements in order for a 403(b) plan to be exempt from ERISA. Basically, the regulation requires that the employer have very limited involvement in the plan and that all rights under the annuity contract or custodial account be enforceable solely by the employee.

Field Assistance Bulletin 2007-02 further discussed the exemption from ERISA for certain 403(b) plans. In the FAB, the Department of Labor stated that the adoption of a plan document would not cause the 403(b) plan to become subject to ERISA. However, the employer could not have responsibility for discretionary determinations in administering the plan. For example, the employer cannot process distributions, make determinations regarding hardship distributions or determine eligibility for loans.

The ERISA exemption was further discussed in Field Assistance Bulletin 2010-01. The Department of Labor provided that the employer hiring a third party administrator would violate the ERISA exemption. The FAB also discussed the requirement that participants are offered a reasonable choice of 403(b) contractors and investment products and stated that, in general, more than one contractor and product must be offered. However, the FAB provided that the plan could limit the contractors to one if the employees could transfer or exchange their interest to a 403(b) account of another provider. Additionally, the Department of Labor acknowledged that there are circumstances in which a plan could be limited to one contractor who offers a wide variety of investment products.

D. Universal Availability.

All 403(b) plans must meet the universal availability requirements for 403(b) elective deferrals. In general, this means that all employees must have the right to have elective deferrals contributed on their behalf. There are specific exceptions to this rule in the tax regulations.

One of the requirements of universal availability is that employees must have effective opportunity to make elective deferrals, including notice of the availability of the election. There are no specific rules on the type of notification which is required.

Some commentators have suggested that there is an annual notification requirement. However, the IRS has indicated in informal conversations that there is no specific annual notice requirement. Rather, upon audit, a plan will be required to prove that all employees have adequate notice of their right to make elective deferrals. All employers with 403(b) plans should be able to prove that all employees have notice of their right to make elective deferrals to the plan.

II. PARTICIPANT INVESTMENT ADVICE AND EDUCATION

A. Investment Advice - Background. The PPA amended ERISA and the Code to create a new statutory exemption from the prohibited transaction rules to make it easier for employers to arrange for the provision of investment advice (as opposed to investment education) to participants in 401(k) plans and IRAs. Under the statutory exemption, the investment advice must be provided by a “fiduciary advisor” under an “eligible investment advice arrangement”, which may be structured as either a “level fee” arrangement or a computer model arrangement.

1. Level fee arrangement. Under this arrangement, any fees or compensation received by the investment advisor cannot vary based on the investment options selected by a participant.

2. Computer model arrangement. Under this arrangement, the advisor utilizes an objective computer model, based on generally accepted investment theories, that is independently certified not to inappropriately favor investment options

offered by the fiduciary advisor. Under this exemption, fees or compensation need not be level for the advisor, his or her firm and their affiliates. That is, compensation may vary based on the investment options recommended and selected by the participant.

3. **General requirements.** Under either statutory exemption, the fiduciary advisor must acknowledge that it is acting as a fiduciary and disclose details of its fees, affiliates and services rendered. In addition, the fiduciary advisor is required to submit to an annual audit to evaluate the advisor's compliance with the conditions for the exemption.

B. **New Proposed Investment Advice Regulation.** On February 26, 2010, the DOL released new proposed regulations to implement the statutory exemption. The proposed regulations eliminate a class exemption available under the prior version of the proposed regulations that provided relief for individualized advice following recommendations generated from a computer model or any advice arrangement which would level fees only with respect to the individual employee, agent or registered representative providing investment advice and not at the fiduciary advisor level.

The new proposed regulations also prohibit an affiliate of the fiduciary advisor, or other person in which the fiduciary advisor has a material interest, from receiving compensation that varies as a result of the advisor's advice.

Although the DOL did not make significant changes from the prior regulation regarding the framework for the computer model approach, the DOL did add a new condition requiring that the computer model avoid investment recommendations within an asset class on the basis of a factor that "cannot confidently be expected to persist in the future". The preamble to the regulations suggests that certain factors, such as lower fees, can be expected to persist in the future, while other factors, such as historical performance, are less likely to persist and therefore are less likely to constitute appropriate criteria for asset allocation.

The comment period on the proposed regulations closes on May 5, 2010 and the regulations will be effective 60 days after the publication of final regulations in the federal register.

C. **Investment Education.** Of course, employers may continue to provide general investment education, as opposed to investment advice, to plan participants without meeting the requirements of the prohibited transaction exemption. As long as the investment education is provided in a manner specified in DOL Interpretive Bulletin 96-1, the employer will incur no fiduciary liability for providing this investment education.

IB 96-1 divides investment information and materials into four categories: plan information, general financial and investment information, asset allocation models, and interactive investment materials, and provides that these types of information can be provided to participants as investment education and do not constitute investment advice.

D. **Selecting and Monitoring Advisors and Educators.** As with the selection of other service providers, the selection of a service provider to provide investment advisory or education services is an exercise of fiduciary discretionary authority. Therefore, employers should make these selections very carefully, and document the process used to make and monitor the selections.

III. 404(C)/QDIA UPDATE

A. **General ERISA Section 404(c) Compliance.** In general, ERISA Section 404(c) provides that if participants in a participant-directed individual account plan exercise actual control over the investments of their accounts, in a manner specified in the ERISA Section 404(c) regulations, the fiduciaries of the plan are relieved from liability with respect to those investments. Plans wishing to take advantage of the relief afforded by Section 404(c) must meet the requirements of the Regulations. That is, the Regulations are not merely a safe harbor for compliance with Section 404(c), but rather are the exclusive means for compliance with Section 404(c). The Regulations impose four basic requirements that must be met by a Plan for it to be deemed to give the participant the "opportunity to exercise control" and, therefore, for it to qualify for Section 404(c) relief. In general, Section 404(c) requires that the participant be given: (a) a broad range of investment alternatives; (b) adequately frequent opportunities to give investment instructions; (c) adequate diversification opportunities; (d) adequate information about the investments and investment election procedures.

B. **Mapping of Investments.** Certain rules must be followed by a Plan for it to be deemed to give the participant the

"opportunity to exercise control" when there is a change in the investment options offered under the plan, and as a result, the participant's account is reallocated among one or more remaining or new investment options that are offered: (1) The participant's account must be reallocated among one or more remaining or new investment options that are reasonably similar to the replaced investment options (including characteristics relating to risk and rate of return); (2) No less than 30 days, and no more than 60 days, prior to the effective date of the change, the plan administrator must furnish written notice of the change to the participants, including information comparing the existing and new investment options and an explanation that, in the absence of affirmative investment instructions from the participant to the contrary, the account of the participant or beneficiary will be invested in the remaining or new investment options; (3) If the Participant provides affirmative investment instructions contrary to the change prior to the effective date of the change, the Participant's account must be invested according to that election.

C. Qualified Default Investment Alternatives. Certain rules must be followed by a Plan for it to be deemed to give the participant the "opportunity to exercise control" when no affirmative investment election has been made by the participant: (1) select a "qualified default investment alternative"; (2) provide a QDIA notice to participants at least 30 days in advance of the date of plan eligibility, or at least 30 days in advance of the date of any first investment in a QDIA, and at least 30 days in advance of each subsequent plan year (Special timing rules apply for plans with automatic contribution arrangements.); and (3) generally provide the same 404(c) information to participants invested in the QDIA that you must provide to participants who affirmatively make investment elections.

D. Summary Prospectus. On January 26, 2009, the SEC published rules for an enhanced disclosure framework for mutual funds including a new Summary Prospectus rule, which provides an optional means of complying with the prospectus delivery requirements under section 5 of the Securities Act. Under the new Summary Prospectus rule, a person may satisfy the mutual fund statutory prospectus delivery obligations by sending or giving a Summary Prospectus and by providing the statutory prospectus online at a specified website address. Mutual funds selecting this delivery option must also send the statutory prospectus free of charge to any requestor in paper or by email. In September 2009, the DOL issued a Field Assistance Bulletin stating that the delivery of a Summary Prospectus, both automatically and upon request, by a plan fiduciary or designee to plan participants or beneficiaries satisfies the prospectus delivery requirements of Section 404(c).

E. Proposed Regulations. In August of 2008, the DOL proposed regulations that, upon adoption, would require the disclosure of certain plan and investment-related information, including fee and expense information, on a more regular basis to participants and beneficiaries in participant-directed individual account plans (e.g., 401(k) plans). The proposed regulations also contain proposed conforming changes to the Section 404(c) regulations. We will notify you of any additional guidance from the DOL regarding these proposed changes.

IV. SPD'S: PLAN EXPENSES DISCLOSURE

A. Payment of Plan Administrative Expenses Unless the Plan provides otherwise, the Plan's fiduciary may decide to pay certain expenses of Plan administration out of Plan assets. For defined contribution plans, plan administration expenses may be paid through the use of forfeitures (if the plan document allows), by assessing participant accounts (pro rata or per capita) or by charging individual plan accounts. Since this is a fiduciary decision, it must satisfy fiduciary standards- it must be prudent and made solely in the interests of participants.

B. Allocated Among All Participants- Pro Rata of Per Capita Where the plan is silent or ambiguous on the issue, a fiduciary could decide to charge some administrative expenses to all plan participants either on a pro rata or per capita basis. Where fees or charges to the plan are determined on the basis of account balances, such as investment management fees, a fiduciary could decide to charge participants on a pro rata basis whereas a fiduciary might decide to allocate certain fixed administrative fees such as recordkeeping fees on a per capita basis.

C. Assessing Individual Plan Accounts The Department of Labor has said that a fiduciary could decide, without violating ERISA, to assess reasonable administrative costs for, for example, (1) hardship distributions, (2) QDRO determinations, (3) calculation of benefits payable under different plan distribution options, (4) benefit distribution charges, (4) administrative fees to the accounts of separated vested participants, (5) plan loan costs and (6) the cost associated with a participant's self direction of his or her account to affected individual participant accounts.

D. Summary Plan Description ERISA requires that Summary Plan Descriptions disclose any provisions that may result in a charge or fee, the payment of which is a condition to receipt of a benefit, as well as any provision that may

result in the offset or reduction of any benefit. The SPD should contain language explaining the types of fees that can be paid from the plan and the method of allocation.

V. FBAR REPORTING REQUIREMENTS AND EXEMPTIONS

A. Current Deadline and Background. FBAR requirement for trustees and other fiduciaries of tax-qualified retirement plans extended to June 30, 2010 or June 30, 2011. The filing deadline is June 30 of each calendar year for accounts maintained during the previous year, and is required to be filed by persons with a financial interest in, or "signature or other authority" over, a foreign "financial account" of more than \$10,000. These persons also must note this relationship on Schedule B of their Form 1040 for the year.

In 1970, Congress enacted the Bank Secrecy Act, which was intended to prevent U.S. persons from hiding assets offshore to avoid income tax on those assets and from laundering money. The BSA of 1970 was amended in 2001 by the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (an act within the USA Patriot Act of 2001). One requirement under the BSA is the "Report of Foreign Bank and Financial Accounts" (Form TD F 90-22.1), commonly referred to as "FBAR". These reports generally have been required for almost 40 years for persons with a financial interest in, or "signature or other authority" over, a foreign "financial account" of more than \$10,000. Prior to 2001, IRS enforcement of the FBAR filing requirement was lax. Following the 2001 amendments to the BSA, enforcement, and the penalties for filing failures increased significantly. Non-willful violations can result in a \$10,000 penalty, while willful violations can trigger a penalty of the greater of \$100,000 or 50% of the balance of the account at the time of the violation. There are also criminal penalties for willful violations

Because of the stated intent of the BSA, as amended, it was widely believed that trustees and other fiduciaries of tax-qualified retirement plans were exempt from the BSA requirements. In addition, under the BSA language, unless the Secretary of the Treasury promulgates rules expressly including governmental entities, many believe that there is no reporting requirement imposed on the States and their subdivisions (or on the tax-qualified plans maintained by these entities), which should prevail over any argument that governmental tax-qualified retirement plans are subject to the FBAR requirements under the general trust inclusion.

Foreign financial accounts subject to FBAR reporting were generally thought to exclude foreign hedge funds and foreign private equity funds. However, in October of 2008, the IRS revised the FBAR and its instructions. One of these revisions modified the definition of "financial account" to include "any accounts in which the assets are held in a commingled fund, and the account owner holds an equity interest in the fund (including mutual funds)".

On August 7, 2009, the IRS issued Notice 2009-62, which provided an extended FBAR filing deadline for (i) persons with signature authority over, but no financial interest in, a foreign financial account, and (ii) persons with a financial interest in, or signature authority over, a foreign commingled fund, such as offshore private equity funds and hedge funds. Under the Notice, these persons have until June 30, 2010, to file an FBAR for the 2009 and earlier calendar years.

B. Recent Guidance and Current Status. On February 26, 2010, the Treasury's Financial Crimes Enforcement Network (FinCEN) issued proposed regulations on the FBAR requirements and the IRS issued Announcement 2010-16 and Notice 2010-23, which (1) temporarily suspends the FBAR filing requirement for persons who are not U.S. citizens, U.S. residents or domestic entities and (2) provides filing relief for certain persons with signature authority over, but no financial interest in, a foreign financial account and persons with interests in certain foreign commingled funds.

The proposed regulations effectively eliminate the FBAR filing requirement for (1) governmental pension, retirement and welfare funds and their employees, (2) qualified retirement plan participants, (3) owners and beneficiaries of traditional or Roth IRAs, (4) public universities, (5) individuals employed by registered investment advisors advising registered mutual funds, and (6) certain tax-exempt investors. However, relief from the filing requirement would generally not be provided to (1) exempt organizations, (2) private universities, (3) trustees or other fiduciaries of qualified retirement plans or (4) employees of publicly traded corporations with signature authority over, but no financial interest in, foreign accounts owned by the corporation's pension plan.

The proposed regulations clarify that foreign accounts include bank accounts, securities accounts, and "other financial accounts", such as annuities or other insurance policies with a cash surrender value issued outside the U.S., foreign mutual funds and similar pooled funds offered to the general public. Although the IRS previously stated that foreign

hedge funds and private equity funds would be reportable, the FinCEN proposed regulations reserve judgment on these accounts pending further study, and pending legislative proposals, which, if passed, would require U.S. individuals to report annually to the IRS with respect to foreign hedge funds and private equity funds.

The proposed regulations do not specify an effective date and do not state whether they may be relied on in preparing FBARs for 2009 or earlier years.

IRS Announcement 2010-16 provides temporary relief for persons who are not U.S. citizens, U.S. residents, or domestic entities, by suspending the FBAR filing requirement for 2009 and earlier calendar years otherwise due on June 30, 2010. U.S. citizens, residents and domestic entities must still meet applicable filing requirements for 2009 and prior years.

IRS Notice 2010-23 provides additional administrative relief to certain persons who may have a filing obligation for 2009 or prior years. The notice extends the FBAR filing deadline for 2009 and prior years from June 30, 2010 to June 30, 2011 for persons with signature or other authority over (but no financial interest in) a foreign financial account. Also, these persons will not have to report relationships with those accounts on their 2009 Form 1040.

The IRS Notice also expressly exempts offshore private equity and hedge funds from the term “commingled fund” for all calendar years prior to 2010, and thus have exempted interests in such funds from FBAR reporting at this time. However, investments in foreign mutual funds (and other traditional foreign accounts, such as a foreign bank account) are not exempt from the reporting requirement. Unless another filing exception applies, persons with a financial interest in any such fund must file a FBAR for 2009 and all prior years on or before June 30, 2010 and report the fund’s existence and location on their 2009 Form 1040.

VI. AUTO ENROLLMENT UPDATE

Automatic enrollment features help to encourage participation by employees in 401(k) plans, 403(b) plans and governmental 457(b) plans by providing for an automatic employee deferral contribution unless the employee affirmatively elects not to make the contribution. There are two types of special automatic arrangements: (1) a Qualified Automatic Contribution Arrangement (“QACA”) which provides for a safe harbor design which exempts the plan from certain nondiscrimination tests; and (2) an Eligible Automatic Contribution Arrangement (“EACA”) which allows for penalty-free distributions of initial automatic contributions in certain circumstances and provides a six month period to distribute excess contributions and excess aggregate contributions without the imposition of the 10% excise tax.

In September 2009, the IRS issued Notice 2009-65. The Notice included two sample plan amendments for 401(k) plans to add automatic contribution features to their 401(k) plans. The amendments provide sample language that does not need to be adopted verbatim and can be adapted to individually designed plans including 403(b) plans and governmental 457(b) plans. The first amendment adds an automatic contribution feature to a 401(k) plan. The second amendment adds an eligible automatic contribution arrangement to a 401(k) plan. It includes the provisions allowing for withdrawal of default elective deferrals.

Also in September 2009, the IRS issued Revenue Ruling 2009-30 which discussed two different plans with automatic contribution provisions. The first plan included automatic contributions but was not intended to be a QACA or EACA. The automatic contribution started at 4% of compensation for the first year of participation. For subsequent plan years, the automatic contribution percentage increased in part based upon increases in the participant’s salary. This resulted in the participants potentially having automatic contribution percentages as different percentages of total compensation.

The IRS ruled that the automatic contributions were elective contributions even though they were not based on a uniform percentage of compensation for each year of participation for all participants. Uniformity is not required for automatic contribution plans that are not QACAs or EACAs.

The second plan was a calendar year plan that was intended to be both a QACA and EACA. For the first plan year, automatic contributions were 3% of compensation. In subsequent plan years, the automatic contribution percentage was increased by 1% as of the payroll beginning on or after April 1. The IRS was asked whether it was permissible for the automatic contribution percentage to increase at a time other than the first day of the plan year. In addition, as a QACA, the plan was required to meet certain minimum uniform percentage amounts. These rules require that the automatic contribution be at least 3% of compensation for the first period of participation. This period begins on the date the

employee first has contributions made under the default election and ends on the last day of the following plan year. The second year after the initial period, the minimum automatic contribution must be 4%. The minimum contribution goes up by 1% for each year after that until it is 6%. Because the percentage increased during the plan year, the IRS was asked whether the minimum required automatic percentages were met.

The IRS ruled that the plan did not lose its QACA and EACA status due to the fact that the automatic percentage increased on the payroll beginning on or after April 1. The fact that the percentage changed during the plan year did not violate the uniform percentage rule for QACAs and EACAs. Furthermore, the plan met the minimum required percentage requirements because the plan met the minimum percentage amounts earlier than required under the QACA rules.

Employers should review any automatic contribution provisions to ensure that the contributions are considered elective contributions. If the plan is intended to be a QACA or EACA, the uniform percentage rules and minimum required percentage amount rules must be met. For any plan with automatic contribution provisions, the notice requirements must be met.

VII. COMBINED DB/401(K) PLANS

As part of the Pension Protection Act in 2006, Congress added Section 414(x) of the Internal Revenue Code to provide for an “eligible combined plan”, which is a combined defined contribution plan and defined benefit plan. The eligible combined plans were not effective until plan years beginning after December 31, 2009 which means that this is the first year that they can be implemented. The eligible combined plans are intended to allow an employer to maintain a defined contribution plan and defined benefit plan on a combined basis which will reduce the administrative burdens and costs of maintaining separate plans.

An eligible combined plan can only be implemented by a small employer. A small employer is an employer who on average employed between two to 500 employees on each business day during the preceding calendar year and who employs at least two employees on the first day of the plan year. There are special rules to determine whether a new employer is a small employer. In addition, the aggregation rules under Code section 414 apply.

The requirements of the Code are applied to the defined benefit and defined contribution plan in the same manner as if each plan were not part of an eligible combined plan. However, certain additional requirements must be met. The defined benefit plan which is part of the eligible combined plan must provide a minimum accrued benefit that is not less than the applicable percentage of the participant’s final average pay. The applicable percentage is the lesser of 1% times the participant’s years of service or 20%. There are also special rules for applicable defined benefit plans that are cash balance plans.

The defined contribution plan that is part of the eligible combined plan must include an automatic contribution provision and must provide a matching contribution at least equal to 50% of elective contributions up to 4% of compensation. A larger matching contribution percentage can be used provided that the rate of matching contribution does not increase as the participant’s rate of elective contribution increases. The defined contribution plan can also provide for nonelective employer contributions but any such contributions are not taken into account in determining whether the minimum matching contribution requirements are met.

There has not been a lot of guidance on eligible combined plans. However, the IRS recently asked for comments on the plans in Notice 2009-35 which was issued in August. Hopefully, more guidance will be forthcoming.

VIII. 2010 REQUIRED PLAN AMENDMENTS FOR INDIVIDUALLY-DESIGNED PLANS

A. The Pension Protection Act (as modified by the Worker, Retiree and Employee Recovery Act of 2008). While tax qualified retirement plans (other than governmental plans, which have an extended amendment deadline) had to be amended for most PPA required provisions by the end of the 2009 Plan Year (i.e., December 31, 2009 for calendar year plans), the Internal Revenue Service, in Notice 2009-97, extended the deadline for amending qualified retirement plans to meet certain specified requirements to the last day of the first plan year that begins on or after January 1, 2010 (i.e., December 31, 2010 for calendar year plans). This extension applies to (1) the requirement under Code Sections

401(a)(29) and 436 related to funding based limits (including benefit restrictions) on benefits and benefit accruals under single employer plans, (2) certain vesting and other special rules applicable to cash balance and other "applicable defined benefit plans" in which the accrued benefit (or any portion of the accrued benefit) is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of a participant's final average compensation (IRC Section 411 (a)(13)), and (3) the deadline for amending certain "applicable defined contribution plans" (which hold certain publicly traded securities) to meet the diversification requirements of IRC Section 401(a)(35). The extension to amend the plan document does not change the effective dates of the requirements. Plans must be operated in compliance with the requirements as of the effective dates under PPA (and WRERA).

B. HEART Act. The Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART) contains certain mandatory provisions and certain optional provisions affecting tax qualified retirement plans (as well as 403(b) and 457(b) plans). With the exception of governmental plans, which have an extended deadline until the end of the 2010 plan year, single employer tax qualified retirement plans must be amended to include the mandatory HEART provisions (and may be amended to include the optional HEART provisions if a Plan Sponsor wishes) by the last day of the 2010 plan year (i.e., December 31, 2010 for calendar year plans). These required provisions must be retroactive to the applicable effective date and the optional provisions may be retroactive to the permitted effective date. The Plan must be operated in compliance with the provisions as of the applicable effective date.

Mandatory provisions:

1) The plan must provide that, if a participant dies while performing qualified military service, the participant's survivors are entitled to any additional benefits (other than benefit accruals relating to the period of qualified military service) that would have been provided under the plan had the participant resumed employment and then terminated employment on account of death. The most common effect of this provision is on plans that provide for 100% vesting if a participant dies while actively employed. Pursuant to HEART, a plan with this provision must provide that a participant who dies while on qualified military service is 100% vested.

2). If an Employer makes differential wage payments (payments made by the Employer to a participant for a period during which the participant is on active duty in military service for more than 30 days and which represents all or a portion of the wage the individual would have received if he or she were performing service for the Employer), the individual receiving the differential wage payment is treated as an employee of the Employer making the payment and the differential wage payment is treated as compensation. IRS Notice 2010-15 provides that, while these wage differential payments may be treated as compensation for purposes of determining contributions and benefits under the plan, they only must be treated as compensation in applying the Code. Thus, they must be treated as compensation for purposes of IRC Section 415.

Optional provisions:

1) Qualified Reservist Distribution. If the requirements are met, there is an exemption from the 10% early withdrawal penalty for Qualified Reservist Distributions made to an employee called to active military service for a period longer than 179 days (or an indefinite period).

2) In Service Distributions. The Plan may be amended to treat an individual who is performing services in the uniformed services while on active duty for a period of 30 days or more as having a deemed severance from employment and eligible for distribution of elective deferrals pursuant to the deemed severance. The distribution would be subject to the 10% early withdrawal penalty. The Plan must then provide that the individual under a deemed severance from employment is prohibited from making an elective deferral or employee contribution during the six month period beginning on the date of the distribution of the elective deferrals.

3) Benefit accruals for employees who do not return to work because of death or disability and vesting credit for those who do not return to work because of disability. The plan may be amended to provide that employees who do not return to work because of death or disability resulting from military service will be treated for benefit accrual purposes (and for vesting purposes in the case of disability) as if they had returned to work the day before the date of death or disability (and thus will be given credit, for benefit accrual and vesting for the period of qualifying military leave.

IX. SETTLOR V. ADMINISTRATIVE EXPENSES

A. Overview. Although it is permissible to charge many benefit plan-related expenses against the assets of the benefit plan, not all expenses incurred in connection with the establishment, maintenance and termination of an ERISA-governed plan may be paid from plan assets. Generally, the Plan may pay only direct plan expenses that are reasonably related to plan administration and authorized by the plan's governing document. The DOL considers activities which relate to the formation, design and termination of a plan as "settlor" functions, and costs related to these functions must be paid by the employer, not the plan.

B. Examples. Examples of settlor expenses which must be paid by the employer include plan design studies, plan amendments to implement plan design changes, expenses related to negotiating potential plan changes with a union, and consulting fees paid to analyze an employer's options in complying with changes in the law. The DOL has indicated that some expenses may be apportioned between the plan and the employer because they involve both settlor functions and administration expenses.

Examples of expenses which may be paid from plan assets (assuming the expenses are reasonable and the plan permits payment) include drafting amendments to comply with changes in the law, expenses to compute participant benefits, most expenses for communication to participants of changes, expenses related to obtaining an IRS determination letter for the plan, and expenses for routine nondiscrimination testing to ensure compliance with tax qualification requirements.

C. Action. Paying expenses from the plan is an ERISA fiduciary issue. Whether the plan or the employer paid specific expenses should be documented and, if the plan paid the expense, the rationale permitting the plan to pay the expenses also should be documented.

EXECUTIVE COMPENSATION

I. UPDATE ON 409A CORRECTION PROGRAM; RECENT IRS INFORMATION DOCUMENT REQUESTS

New Document Failure Correction Program. IRS Notice 2008-113 established a correction program with regard to Code Section 409A "operational" failures by deferred compensation arrangements (as very broadly defined). IRS Notice 2010-6 established a new correction program that permits employers to correct many types of Section 409A "document" failures. Examples of "document" failures that may be corrected under Notice 2010-6 include: (1) impermissible definitions of separation from service, disability, or change in control; (2) impermissible payment events or payment schedules; (3) impermissible payment periods following a permissible payment event; (4) impermissible initial or subsequent deferral election procedures; and (5) a failure to include the six-month delay of payment for specified employees of publicly-traded companies.

If an employer corrects a Section 409A document error using the procedures in Notice 2010-6, the very onerous Section 409A penalties are reduced or totally eliminated. Specifically, no Section 409A penalties apply if: (1) the document failure is corrected by December 31, 2010, or (2) the document failure is corrected after December 31, 2010, but the corrected plan provision does not affect the operation of the plan within one year after the correction. In other situations, various reduced Section 409A penalties may apply. For example, the Notice reduces by 50%, or in some cases 75%, the amount includible in the participant's income and the various additional taxes under 409A for certain document failures if the corrected plan provision affects the operation of the plan within one year following the date of correction.

The following requirements must be satisfied to use the correction program in Notice 2010-6: (1) the document failures must be inadvertent and unintentional; (2) the employer must correct all deferred compensation arrangements having the same type of error; (3) the employer must not be currently being audited by the IRS (through 2011, the employer is treated as not being under audit unless the specific plan provision being amended has been identified as a problem in an IRS audit); (4) the affected employee's income tax return must not be currently being audited by the IRS; (5) both the employer and employee must attach information regarding the correction to their respective income tax returns for the taxable year in which the correction was made. (Note that the correction program is not available for stock rights plans or so-called "linked" plans – that is, plans that provide a benefit that is determined by the amount deferred under, or plans for which the time or form of payment is affected by the payment provisions of, one or more other qualified or

nonqualified deferred compensation plans.)

(On a helpful side note, Notice 2010-6 states that the following two common nonqualified plan provisions will not be treated as Section 409A document failures if the plan is actually operated in a manner that complies with Section 409A: (1) a plan states that payment will be made "as soon as administratively feasible" after a permissible payment event; (2) a plan uses the term "termination of employment" instead of the required "separation from service" term.)

IRS Information Document Requests. In 2009, the IRS began a program of issuing Section 409A "Information Document Requests" to employers that will result in the issuance of 2,000 IDR's per year for each of the next three years. These IDR's contain detailed questions about the employer's document and operational compliance with Section 409A. Naturally, in light of this active IRS audit program, employers should carefully review their Section 409A compliance efforts to ensure that all of their affected arrangements are in compliance with the various document and operational rules.

II. FUNDING LIMITS ON DISTRESSED EMPLOYERS

A. Internal Revenue Code section 409A Limitations on NQ Plans if Pension is "at risk". As part of the qualified pension plan funding rules, the Pension Protection Act of 2006 amends Code section 409A to add a restriction that provides that any assets set aside (such as in a "rabbi trust") or restricted to the payment of benefits for "covered employees" under a nonqualified plan will be included in income and subject to the very onerous tax penalties of Code Section 409A (i.e., immediate ordinary income tax, a 20 percent penalty tax, and interest penalties) if the assets are set aside or restricted (a) while a qualified pension plan sponsored by the employer (or by a member of the employer's controlled group) is in "at-risk status" under the new funding rules; (b) while the qualified pension plan's employer-sponsor is in Chapter 11 bankruptcy proceedings; or (c) during the 12-month period beginning 6 months prior to a distress termination date of a qualified pension plan sponsored by the employer (or by a member of the employer's controlled group).

A "covered employee" for purposes of these new restrictions is any employee of a publicly traded company who is (or was at termination of employment) (a) the CEO, or acting CEO; (b) required to be listed in a proxy statement's compensation disclosure statement; or (c) an "insider" subject to the insider trading rules under the Securities Exchange Act of 1934. (While these rules clearly apply to publicly traded companies, some commentators have interpreted the language of these new restrictions to apply to the CEO, or acting CEO, of companies that are not publicly traded, an issue that will need some clarification.)

Employers that sponsor (or whose controlled group members sponsor) nonqualified plans and qualified pension plans will need to be very mindful of this new rule and will need to put in place procedures to "shut off" nonqualified plan "covered employee" deferrals or contributions to a "rabbi trust" or similar arrangement should one of the three situations occur.

PPA established new rules that, in very general terms, (i) require underfunded pension plans to become fully funded within seven years; (ii) impose new mortality and interest rate assumptions to be used in determining the plan's liabilities and participant benefits (e.g., lump sums); (iii) with exceptions for small plans and collectively bargained plans, impose onerous funding and benefit restrictions, including special actuarial assumptions, on plans that are "at risk" plans (generally, plans with a funding percentage for the preceding year of less than 80 percent (without regard to the special "at risk" actuarial assumptions) and a funding percentage for the preceding year of less than 70 percent (taking into account the special "at risk" actuarial assumptions)). The 80 percent prong is generally phased in as follows by substituting the following percentage for "80 percent": below 65 percent funded in 2008, below 70 percent funded in 2009, below 75 percent funded in 2010 and below 80 percent funded in 2011 and future years.

B. Recent IRS Informal Response. The following is a 2009 IRS Q&A of the ABA Joint Committee on Employee Benefits:

Q&A 29. Section 409A – Prefunding of Nonqualified Deferred Compensation Plans

Do Section 409A(b)(3)'s restrictions on prefunding nonqualified deferred compensation of covered employees during a restricted period with respect to qualified single-employer defined benefit plan apply to the CEO of a non-public entity?

This question arises because Section 409A(b)(3)(D)(ii) defines covered employee as including individuals described in Section 162(m)(3). Section 162(m)(3)(A) provides: "For purposes of this subsection, the term 'covered employee' means any employee of the taxpayer if ... as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity." While Section 162(m) only applies to public companies, this text could be read as subjecting CEOs of all entities, including privately held companies and not-for-profit entities, to the prefunding restriction in Section 409A(b)(3).

Proposed Response: Section 409A(b)(3)'s restrictions on prefunding nonqualified deferred compensation of covered employees during a restricted period with respect to qualified single employer defined benefit plan apply only to covered employees of public companies.

IRS Response: The Service representative indicated that there is not an answer on this question and that it is an issue that is under study.

III. FICA DEVELOPMENTS – MEDICAL INTERNS AND MI COURT SEVERANCE CASE

A. Overview - Resident. Hospitals and medical schools (and medical residents) for years filed FICA (social security and Medicare tax) refund claims based on the position that medical residents were eligible for the so called student exception from the FICA tax. This resulted in numerous court cases prior to issuance of IRS regulations effective April 1, 2005 which finally resolved the issue going forward.

B. IRS Announcement – Resident. On March 2, 2010, the IRS announced that it has made an "administrative determination" that medical residents are excepted from FICA taxes based on the student exception for tax periods ending prior to April 1, 2005, when new IRS regulations went into effect. The IRS will contact affected hospitals, universities and medical residents who filed FICA refund claims for those periods.

C. Severance Case. Severance pay is included in income and subject to withholding. A U.S. District Court in Michigan recently held that severance plan payments made in connection with an involuntary reduction in force are not "wages" under FICA. See United States v. Quality Stores, Inc., 2010 WL 679136 (W.D. Mich. 2010). The Court's holding is contrary to a long-standing IRS ruling on the issue and opens the door for employer to file for FICA refunds.

IV. NQ PLAN ACCELERATIONS/TERMINATING NQ PLANS

A. General Rule. Generally, payments under a deferred compensation plan may not be accelerated. However, under 409A an employer may accelerate payments under certain limited circumstances. However, except for an unforeseeable emergency, the participant may not make any direct or indirect request for accelerated payment. Summarized below are the payment acceleration provisions we most frequently encounter.

B. Limited Cashouts- Termination of a Participant's Participation. The employer may cash a participant out by making a lump sum payment of all amounts deferred under the Plan by the participant, provided that (a) the payment results in the termination and liquidation of the entirety of the participant's interest under the Plan and under any other plans of the participant that must be aggregated with the Plan under Section 409A's plan aggregation rules (e.g. any other nonqualified account balance deferred compensation plans sponsored by any controlled group member in which the participant participates), and (b) the payment is not greater than the applicable dollar amount under section 402(g)(1)(B) (e.g. \$16,500 for 2010).

C. Plan Terminations and Liquidations-Termination of All Participants' Participation. The employer may terminate and liquidate a Plan under any one of the following circumstances:

1. Within 12 months of a corporate dissolution, or with the approval of a bankruptcy court, provided that the amounts deferred under the Plan are included in the participants' gross incomes at the time specified by the Section 409A Regulations.

2. Within the 30 days preceding or the 12 months following a "change in control" event (as defined for purposes of Section 409A), where the employer is the Plan "sponsor" after the change in control, provided that (i) the employer

terminates and liquidates all similar nonqualified plans for all participants affected by the change in control and (ii) all participants are required to receive all amounts of compensation deferred under the terminated plans within 12 months of the date the employer irrevocably takes all necessary action to terminate and liquidate the agreements.

3. If the following requirements are met - (i) the termination and liquidation does not occur proximate to a downturn in the financial health of the employer; (ii) with respect to each affected participant, the employer terminates and liquidates all similar nonqualified plans sponsored by the employer or by any other controlled group member; (iii) all payments are made to participants no earlier than 12, and no later than 24, months after the date the employer takes all necessary action to irrevocably terminate and liquidate the Plan; and (iv) the employer does not adopt a new similar nonqualified plan with respect to an affected participant at any time within three years following the date the employer takes all necessary action to irrevocably terminate and liquidate the Plan.

D. Payment of Employment, Federal, State, Local, or Foreign Taxes. The employer may accelerate payment to pay the Federal Insurance Contributions Act (FICA) tax imposed on compensation deferred under the Plan, to pay any state, local, or foreign tax obligations arising from participation in the Plan, or to pay any federal, state, local or foreign income taxes due upon a vesting event under a Code section 457(f) Plan.

E. Payment Upon Income Inclusion Under Section 409A. The employer may accelerate payment of the amount required to be included in income as a result of a failure to comply with the requirements of Section 409A and the Section 409A Regulations.

F. Domestic Relations Order. The employer may accelerate a payment to an individual other than the participant to the extent necessary to fulfill a domestic relations order.

G. Conflicts of Interest. The employer may accelerate a payment to the extent necessary (a) for any Federal officer or employee in the executive branch to comply with an ethics agreement with the Federal government, or (b) to avoid the violation of an applicable Federal, state, local, or foreign ethics law or conflicts of interest law (including where such payment is reasonably necessary to permit the participant to participate in activities in the normal course of his or her position in which the participant would otherwise not be able to participate under an applicable rule).

H. Avoidance of a Nonallocation Year under Section 409(p). The employer may accelerate a payment to prevent the occurrence of a nonallocation year (within the meaning of Section 409(p)(3)) under an employee stock ownership plan, provided that certain distribution requirements are met.

I. Certain Offsets. The employer may accelerate a payment as satisfaction of a debt of a participant to the employer, where (a) such debt is incurred in the ordinary course of the service relationship between the employer and the participant, (b) the entire amount of the accelerated payment in any of the employer's taxable years does not exceed \$5,000, and (c) the accelerated payment is made at the same time and in the same amount as the debt otherwise would have been due and collected from the participant. This may raise constructive receipt issues.

J. Bona Fide Disputes as to a Right to a Payment. The employer may accelerate a payment as part of a settlement between the participant and the employer of an arm's length, bona fide dispute as to the participant's right to the deferred amount. (A payment will be presumed not to meet this exception (a) unless the payment is subject to a substantial (i.e., 25% or more) reduction in the value of the payment made in relation to the amount that would have been payable had there been no dispute as to the participant's right to the payment, or (b) if the payment is made proximate to a downturn in the financial health of the service recipient.)

K. Unforeseeable Emergency. At the election of the participant and upon satisfactory proof, the employer may accelerate a payment if the participant suffers an "unforeseeable emergency", as defined under Section 409A.

V. BONUS DEDUCTIBILITY IRS GUIDANCE

A. Bonus Deductibility. IRS GCM 200948040, issued July 28, 2009, confirms that a bonus is not deductible in the year in which performance is measured if additional services are required in the following year (in which the bonus is actually paid). The employer was an "accrual basis" taxpayer. The bonus program measured performance in one year, but did not pay the bonus until 2 ½ months after the end of that year, and required the employee to be employed on the

bonus payment date to receive any part of the bonus payment (if not employed on that date, the bonus was forfeited). IRS said: "economic performance does not occur and the liability is not fixed until the date that bonuses are paid because services must continue until that time ". Therefore, the bonuses were not deductible by the employer until paid.

B. Deferred Compensation Implications. Bonuses described in the IRS GCM (and other similarly restricted performance based compensation) should not be treated as "earned", and should be treated as "subject to a substantial risk of forfeiture", until paid. Under Code section 457(f) and Code section 409A, the rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

1. Short term deferral treatment under Code section 409A. A payment is considered a short-term deferral if the terms of the plan do not provide for a deferred payment and require that payments be made to the service provider (and the payments are actually or constructively received by the service provider) by 2 ½ months from the later of (1) the last day of the service provider's taxable year; or (2) the last day of the service recipient's year, in which the amount is no longer subject to substantial risk of forfeiture.

2. Deferral Election Timing. Code section 409A generally requires that participant deferral elections must be made by the end of the calendar year prior to the calendar year in which the compensation to be deferred will be earned, and it prohibits midyear changes to these elections. A deferral election includes an election as to the time of the payment, the form of the payment, or both the time and form of the payment.

VI. INTERMEDIATE SANCTIONS UPDATE

A. Intermediate Sanctions Generally. Under the IRS's intermediate sanctions regulations, the IRS will impose excise taxes on "disqualified persons" and organizational managers of a 501(c)(3) or 501(c)(4) organization (in lieu of revoking the tax-exempt status of an organization) if a disqualified person's compensation package is not reasonable. If the compensation package is not reasonable, excise taxes can be imposed. In general, a 25% excise tax (i.e., 25% of the value of the excess benefit) is imposed on the disqualified person (plus an additional 200% excise tax if the excess benefit transaction is not timely corrected), and a 10% excise tax (up to \$20,000) is imposed on the organizational managers who knowingly and willfully approved the transaction.

B. Benefits Must be Provided As Compensation for Performance of Services. To be reasonable, among other requirements, a benefit provided by the organization to a disqualified person must be provided in exchange for the performance of services (and the value of the benefit must be reasonable in light of the services performed). One often overlooked nuance in the intermediate sanctions regulations is the requirement that the organization clearly indicate its intent to treat the benefit as being consideration for the performance of services. In plain terms, this requires the organization to report taxable compensation elements as taxable income. Unless properly reported, the benefit may be subject to the excise taxes described above.

C. Reporting of Benefits. An organization or disqualified person meets the reporting requirements if: (1) the organization reports the economic benefit as compensation on an original or amended Form W-2, Form 1099, or Form 990; or (2) the disqualified person reports the benefit as income on the person's original or amended Form 1040. Generally, these reporting requirements must be met before the commencement of an IRS examination of the organization or the disqualified person for the taxable year in which the transaction occurred, or before receipt of written notice by the IRS of a potential excess benefit transaction involving either the organization or the disqualified person.

D. Exception for Failure to Report Due to Reasonable Cause. If the failure to report taxable income is due to reasonable cause, the intermediate sanctions penalties do not apply. To fall under this reasonable cause exception, the organization must establish that there were significant mitigating factors with respect to its failure to report or that the failure arose from events beyond the organization's control, and that the organization acted in a responsible manner both before and after the failure occurred.

E. Other Exceptions. Intermediate sanctions penalties also may be avoided under this if the organization can show (i) an approved initial written employment contract executed on or before the date the compensation is provided that describes the benefit, or (ii) the organization considered the benefit in its intermediate sanctions review process on or before the date the compensation is provided. (Of course, the benefit must still be reasonable, as required by the other

provisions of the intermediate sanctions regulations.)

LABOR AND EMPLOYMENT LAW

I. Sexual Orientation in the Workplace.

The Employment Non-Discrimination Act (“ENDA”) is a proposed federal bill that, if passed, would prohibit workplace discrimination on the basis of sexual orientation and gender identity. The bill specifically exempts the U.S. military, veterans' service groups, and religious organizations, and does not require employers to provide benefits to domestic partners of their employees. ENDA has been introduced almost every year since 1994, originally as a bill designed to prohibit discrimination on the basis of sexual orientation only, with subsequent proposals (including the most recent) including gender identity as a protected class. Although passage of ENDA in 2010 appears unlikely, employers must nevertheless be aware of state and local laws that prohibit discrimination on the basis of sexual orientation (e.g., Maryland) and gender identity (e.g., Baltimore City), and should make certain that these protected classifications are included in applicable discrimination and harassment policies. Moreover, the annual reintroduction of ENDA and the strong support both for and against its passage suggests that sexual orientation/gender identity-related workplace protections are perceived by many as controversial, thus highlighting the need for periodic sensitivity training with respect to these issues.

II. Americans with Disabilities Act Amendments Act.

A. **Effective Date.** The ADA Amendments Act of 2008 (“ADAAA”) became effective on January 1, 2009. In the ensuing 15 months, there has been an increased zeal on the part of the EEOC with respect to ADA enforcement. As a result, any disciplinary action of any kind (e.g., written warnings, suspensions, discharges) that arises out of or is related to an employee’s known, suspected or professed medical condition is a potentially serious legal event, and warrants a close analysis of the applicability of the ADA (and a host of federal and state laws) to the potential disciplinary act.

B. **Definition of “Disability”.** The ADAAA retains the ADA's basic definition of "disability" as an impairment that substantially limits one or more major life activities, a record of such an impairment, or being regarded as having such an impairment. However, it changes the way that these statutory terms should be interpreted in several ways. Most significantly, the Act:

(i) **Substantial Limitations.** Directs the EEOC to revise that portion of its regulations defining the term "substantially limits" to something that reflects the ADAAA’s broader view of ADA coverage.

(ii) **Major Life Activities:** Expands the definition of "major life activities."

(iii) **Mitigating Measures:** States that mitigating measures (e.g., medications, prosthetics, etc.) other than "ordinary eyeglasses or contact lenses" shall not be considered in assessing whether an individual has a disability. Under the ADAAA, impairments are to be assessed in their unmitigated state when determining whether the individual is substantially limited in a major life activity.

(iv) **Episodic Impairments/Remission** – Clarifies that an impairment that is episodic or in remission is a disability if it would substantially limit a major life activity when active.

(v) **“Regarded As” Disabled:** Provides that an individual subjected to an action prohibited by the ADA (e.g., failure to hire) because of an actual or perceived impairment will meet the "regarded as" definition of disability, unless the impairment is transitory and minor.

(vi) **Broad Interpretation.** Emphasizes that the definition of "disability" should be interpreted broadly, i.e., to the “maximum extent” permitted by the ADA and the ADAAA.

III. National Defense Authorization Act/FMLA

On October 28, 2009, President Obama signed the National Defense Authorization Act for Fiscal Year 2010 (NDAA), which became effective on the signing date. The NDAA, among other things, amends the Family and Medical Leave Act (FMLA) by expanding the military family leave provisions of the FMLA:

(i) The NDAA expands qualifying exigency leave to include all eligible family members (spouse, son, daughter, parent, or next of kin) of active duty service members. In addition, qualifying exigency leave is now available to eligible family members of all service members (including those in the regular Armed Forces), who are deployed to a foreign country. (Prior to the October amendments, only an employee with a family member serving in the National Guard or in a Reserve component of the armed forces was eligible for Qualifying Exigency Leave.)

(ii) FMLA provides eligible employees up to 26 work weeks of unpaid leave to provide Military Caregiver Leave for the serious injuries of certain service members. Under the NDAA, “serious injury or illness” includes illnesses and injuries that existed before the beginning of the service member’s active duty that were aggravated by his or her active duty service, even if the illness manifested itself before the active duty service. In addition, employees now have five (5) years after the family member’s discharge from the military to take Military Caregiver Leave. (Prior to the NDAA, Caregiver leave was restricted to caring for family members who had not yet been discharged from the armed forces, and did not cover preexisting conditions.)

FMLA policies should be amended to reflect these new provisions.

IV. Maryland Workplace Fraud Act.

Effective October 1, 2009, the Maryland Workplace Fraud Act (“WFA”) prohibits employers in the construction and landscaping services industries from classifying workers as independent contractors rather than employees. The Act is designed to restrict employers in these covered industries from trying to avoid the costs (unemployment, workers’ compensation, etc.) associated with hiring employees (as opposed to engaging independent contractors). Under the WFA, individuals hired to perform services for a construction or landscaping business are presumed to be employees, unless the employer can demonstrate that the employee is “exempt” from the Act (i.e., an individual who, among other things, either works alone or with family members only; who performs work free from direction and control; who furnishes his/her own tools; and exercises complete control over the management and operations of the business), or the employer can prove that:

(i) The individual who performs the work is free from direction and control over its performance both in fact and under the contract;

(ii) The individual customarily is engaged in an independent business or occupation of the same nature as that involved in the work; and

(iii). The work is either: (a) outside the normal course of business of the company for whom the work is performed, or (b) is performed outside of the place of business of such a company. (Work is outside of the usual course of business if the individual performs the work off the employer’s premises; the individual performs work that is not integral to the employer’s operation; or the work performed is unrelated to the employer’s business.)

Employers who violate the Act may be required to pay a penalty of up to \$1,000 for each misclassified employee (\$5,000 for a knowing violation). Individuals misclassified as independent contractors can seek restitution for damages, and may also be eligible for treble damages for a knowing violation of the Act.

V. WAGE & HOUR UPDATE

A. Overview. Under the current administration, the U.S. Department of Labor has made significant changes, particularly in the Wage & Hour Division (WHD). These changes range from technology, to funding, to policy, and other aspects of the administration of Wage & Hour laws.

(i) Funding & Budget. Depending on the administration, funds significantly fluctuate for government agencies. The funding for the WHD under the current administration has substantially increased, providing an opportunity for the WHD to increase its numbers, improve technology, and increase its enforcement. For example, over the course of the last year, the WHD has hired over 250 new investigators, increased support staff, opened new field offices, and improve their efficiency through the introduction of new technology.

(iii) Opinion Letter Policy. The WHD has chosen to abandon the customary practice of issuing fact specific opinion letters. They are now issuing what they call Administrator Interpretations that include references to the statutes, regulations, and applicable case law and give general guidelines providing legal clarification to legal issues without addressing the specific factual scenarios involved.

(iv) Hot Goods. Under §15(a)(1) of the Fair Labor Standards Act (FLSA), an employer is prohibited from shipping, offering to ship, or sell in interstate commerce any goods that were produced by employees employed in violation of FLSA §§6, 7, or 14. Under the previous administration, the hot goods provision of the FLSA was rarely invoked in enforcement. The current administration has chosen to enforce the FLSA using this provision.

(v) Independent Contractors. The U.S. Government is concerned, on an interagency level, about the misclassification of independent contractors. Specifically, the WHD, IRS, and other agencies have entered into an interagency agreement to track misclassifications. This could result in standard penalties under the FLSA as well as potential civil money penalties (CMPs) where the misclassification is willful.

(vi) Litigation. The Solicitor's Office of the WHD has made specific agreements to increase the number of cases it litigates.

(vii) Liquidated Damages. Traditionally, the WHD has pursued liquidated damages under FLSA §16 in cases where the violations were willful and repeat. However, there is currently discussion within the WHD that liquidated damages will be pursued on ALL cases, including first, second, and willful and repeat investigations.

(viii) Civil Money Penalties. Finally, the previous administration would issue CMPs on a mitigated basis, taking into account all mitigating factors. The current administration has chosen to issue CMPs in their maximum amount. The amount may be mitigated where certain factors exist, but the default is to issue maximum CMPs where applicable.

B. Donning and Doffing

“Hours worked” is a murky topic under the Fair Labor Standards Act (FLSA). It is complex and very fact specific. One of the more complicated hours worked issues is donning and doffing. Generally, when employees, for their own convenience, change clothes or wash up before or after they start work, such activities are regarded as “preliminary” or “postliminary.” The time spent changing or washing would have to be counted as time worked only if payment is required under a contract, custom, or practice. However, time spent by employees in changing clothes or washing up at the beginning or end of the workday is considered part of their “principal activities” whenever the changing or washing is required by the nature of the workers' jobs.

The FLSA does contain a limited excepts certain employers from the requirement of paying donning and doffing time where the payment of donning and doffing has been excluded as a part of a bona fide collective-bargaining agreement.

C. Administrative Exemption

In order to satisfy the administrative exemption, an employee's job duties and compensation must meet all of the following tests:

(i) The employee must be compensated on a salary or fee basis as defined in the regulations at a rate not less than \$455 per week;

(ii) The employee's primary duty must be the performance of office or non-manual work directly related to the management or general business operations of the employer or the employer's customers; and

(iii) The employee's primary duty must include the exercise of discretion and independent judgment with respect to

matters of significance.

Both tests two (“directly related to the management or general business operations of the employer or the employer’s customers”) and three (“exercise of discretion and independent judgment with respect to matters of significance”) are the subject of great confusion, and, as a result, frequent (albeit unintended) abuse.

Many employers take the position that, since everyone else in the industry classifies certain employees as administratively exempt, they are safe to do likewise. A recent DOL Administrator’s Interpretation reveals the danger of such a position. Historically, financial institutions have treated mortgage loan officers as exempt, since they (i) perform non-manual work related to general business operations, and (ii) they exercise discretion and independent judgment with respect to matters of significance. In spite of the fact that an opinion to the contrary could wreak havoc on an entire industry, the DOL recently stated:

“careful examination of the law as applied to the mortgage loan officers’ duties demonstrates that their primary duty is making sales and, therefore, mortgage loan officers perform the production work of their employers. Work such as collecting financial information from customers, entering it into the computer program to determine what particular loan products might be available to that customer, and explaining the terms of the available options and the pros and cons of each option, so that a sale can be made, constitutes the production work of an employer engaged in selling or brokering mortgage loan products. Such duties do not relate to the internal management or general business operations of the company; they do not involve servicing the business itself by providing advice regarding internal operations, unlike the duties of employees working in, for example, a firm’s human resources department, accounting department, or research department. The typical job duties of a mortgage loan officer comprise a financial services business’ marketplace offerings, the selling of loan products. Their duties involve the day-to-day carrying out of the employer’s business and, thus, fall squarely on the production side of the business.”

Employers must be prepared to engage in a comparable skeptical analysis of their administrative employees to ensure that current misclassifications do not result in future damages.

D. Travel Time and Breaks

1. Travel Time. While circumstances vary depending on the specific facts involved, there are several general guidelines that can help employers know whether they are required to pay non-exempt employees for travel time to, from and during work.

(i) Home to Work. Commuting time is generally not compensable time under the FLSA. This may also include where an employee is required to report to varying work sites.

(ii) Special One-Day Assignments. An employer may be required to pay for travel time if an employee is required to report to another city on a special one day assignment, less the regular commuting time of the employee.

(iii) Travel All in a Day’s Work. Travel that is a part of an employee’s principal activity which occurs during the workday is compensable time. This may include time spent traveling between work sites.

(iv) Overnight Stay. Where an employee is required to travel outside their home community for an overnight stay, the employer is required to pay for the time spent traveling that occurs during the employee’s regular work schedule.

2. Break Times. Prior to the enactment of the Patient Protection and Affordable Care Act (PPACA), the FLSA did not require that an employer provide any breaks to employees. (Note that state and local regulations may differ from the FLSA.) Even without requiring breaks, the regulatory guidance from the DOL did provide guidance relating to the difference between breaks and lunches. And now with the enactment of the PPACA, employers are required to provide a break for nursing mothers.

(i) Rest Breaks. Rest breaks are standard in industry, usually last 20 minutes or less, and are considered hours worked. These breaks must be compensated.

(ii) Meal Breaks. Meal breaks generally last for 30 minutes or more, the employee is completely free from duty, and the employee does not perform any work during that time. These breaks are not considered hours worked and are not

required to be paid. Under certain limited circumstances, an employee's meal break may take no less than 20 minutes, but this will usually require both an agreement between the employee and employer as well as it must be reasonable.

(iii) Nursing Mothers. The PPACA amended the FLSA to require an employer to provide reasonable breaks for nursing mothers within one year of the birth of the child. The employer does not need to compensate the employee for these breaks. However, the employer is required to provide a private area that is not a bathroom, free from view, and free from intrusion for the employee. Regular coverage principles apply, but a limited exception applies to employers who have less than 50 employees and can show that it would cause an undue hardship.