ROBINSON & COLE LLP
Employee Benefits & Compensation

EEOC Proposes Rules Generally Exempting Retiree Health Plans from ADEA

Yesterday the EEOC proposed rules exempting certain age based changes to employer-sponsored retiree health plans from ADEA's age discrimination provisions. The exemption allows employers to alter, reduce or eliminate employer-sponsored retiree health benefits when retirees become eligible for Medicare or a state-sponsored retiree health benefits program. This exemption is to be narrowly construed to apply solely to such eligibility for government-sponsored coverage and may not be used as a means to otherwise avoid ADEA.

Final Regulations Released on Catch-up Contributions

The IRS has released Final Regulations, effective January 1, 2004, regarding catch-up contributions to 401(k), 403(b) or 457 plans. Plans may elect to allow participants who have reached the age of 50 to make catch-up contributions in the amount of $2,000 in 2003, $3,000 in 2004, $4,000 in 2005 and $5,000 in 2006. Catch-up contributions are not subject to the general contribution limits and are not taken into account for nondiscrimination testing purposes. A contribution qualifies as a catch-up contribution if it exceeds a statutory limit (such as the $12,000 deferral limit in effect for 2003), the actual deferral percentage limit, or an employer provided limit. An employer provided limit is a limit on the amount of deferrals an employee can make under the plan. It was unclear under the Proposed Regulations whether a limit on deferrals implemented by a plan administrator would constitute an employer provided limit under the plan. The Final Regulations clarify that if a plan administrator has the authority to limit deferrals, deferrals in excess of the plan administrator's imposed limit qualify as catch-up contributions.

Catch-up contributions are subject to a universal availability requirement. Employers are not required to offer catch-up contributions, but if a plan permits catch-up contributions, the ability to make catch-up contributions must be made available under all plans maintained by any employer within the same controlled group as the plan sponsor. The universal availability requirement has been source of concern for employers. The Final Regulations resolve part of this problem by providing that employees covered by collective bargaining agreements and certain nonresident aliens are not protected by the universal availability requirement. The Final Regulations do not exempt participants in different qualified separate lines of business from the universal availability requirement.

IRS Finalizes Section 457 Regulations

The IRS issued final Section 457 regulations on July 11, 2003. The regulations, which govern deferred compensation plans of tax exempt employers and state and local governments, are largely identical to the proposed regulations issued in May 2002. The Final Regulations contain a few significant changes. Under the proposed rules, excess deferrals to a tax exempt plan could not be corrected and would result in immediate disqualification of the plan. However, the proposed rules permitted the correction of excess deferrals to state and local government plans through corrective distributions to plan participants. The Final Regulations largely eliminate this differential treatment by permitting plans of tax exempt entities to correct excess deferrals through corrective distributions, provided that such distributions are made by the April 15 following the end of the taxable year in which the excess deferral was made.

The Final Regulations also create a special rule permitting a participant who is retiring or who has otherwise severed his employment to defer sick pay, vacation pay or back pay that is not yet payable to a 457 plan at any point prior to retirement, but prior to the time such amounts would be payable. The Proposed Regulations only permitted such amounts to be deferred if the decision to defer was made prior to the first day of the month in which the participant retired.

Under the Proposed Regulations, amounts rolled into a governmental 457 plan from a qualified plan, IRA or 403(b) plan subjected a participant's entire account balance to the 10% early withdrawal penalty despite the fact that distributions from governmental plans are typically exempt from such penalty. The Final Regulations clarify that the 10% early withdrawal penalty will not be applicable to the portion of a participant's account excluding rollovers if separate accounts are maintained for rollover contributions and plan contributions. The regulations also provide that two rollover accounts may be used to keep monies rolled over from a governmental plan separate from monies rolled over from qualified plans, IRAs or 403(b) plans for purposes of applying the early withdrawal penalty.

Guidance Issued on COBRA Small Employer Plan Exception

The IRS has issued guidance on the application of the COBRA small employer plan exception. Under COBRA, employers who had fewer than 20 employees in the preceding year are not required to offer COBRA continuation coverage to employees (however, state law may still require the employer to provide continuation coverage). An employer falls under this small employer exception if it employed fewer than 20 employees on 50% of its typical business days during a year. All related entities in a controlled group are combined in determining the number of employees.

In the case of a transaction where two businesses are combined, employers have found the small employer exception rules difficult to apply since the employees were employed by separate entities in the preceding year. The guidance clarifies the application of the exception in cases where the combined entities had more than 20 total employees in the preceding year. The consequences differ depending on whether an employer is acquired in an asset purchase or a stock purchase transaction. If a small employer is acquired in a stock purchase, the employer's group health plan will be subject to COBRA on the date that the groups of employees are combined if more than 20 employees were employed by the seller and the buyer combined in the preceding year. However, if a small employer is acquired in an asset purchase, the employer's group health plan will not become immediately subject to COBRA. In the case of a sale of assets, the normal small employer exception rules apply and the plan will be subject to COBRA in the year following the year in which the new entity no longer falls under the small employer exception and employs more than 20 employees. The guidance is consistent with theories used in corporate transactions in the past based on existing regulations.

Proposed Regulations Issued Governing Incentive Stock Options

In June, the IRS issued comprehensive Proposed Regulations governing incentive stock options. The Proposed Regulations provide that incentive stock option grants and option plans must be documented in paper or electronic form and include the date of the grant, the number of shares subject to the option grant and the price of the option. The Proposed Regulations provide guidance on the definition of incentive stock option, permissible terms of option plans and grants, the $100,000 limitation, modifications to the terms of option grants, and option record retention. The Proposed Regulations do not change prior regulations regarding stockholder approval, but provide additional guidance and examples of when stockholder approval is required.

Advance Notice No Longer Necessary when Eliminating Distribution Options

Proposed Regulations issued by the IRS eliminate the requirement that participants be provided with 90 days advance notice when a plan sponsor eliminates the ability to elect payment under a particular distribution option in a defined contribution plan. The Proposed Regulations, which are intended to reflect changes made to the Tax Code by EGTRRA, are effective immediately. A defined contribution plan sponsor can amend its plan to eliminate a form of distribution, provided that participants have the ability to elect an equivalent lump-sum distribution option. The lump-sum distribution must be based on the same or greater portion of the participant's account as the distribution option that has been eliminated. Advance notice of the adoption of the amendment to participants is no longer necessary.

Qualified Retirement Plan Distributions Can't be Used as Pre-Tax Contributions for Health Insurance Premiums or Medical Expenses

The IRS has issued a Revenue Ruling confirming its position that qualified retirement plan distributions cannot be used to fund health insurance on a pre-tax basis. If a retiree elects to have part of a retirement plan distribution paid to a cafeteria plan to fund health insurance premiums, the contribution to the cafeteria plan is not eligible for pre-tax treatment and the amount distributed from the retirement plan is includable in income when it is distributed. Pre-tax treatment is also unavailable if the distribution is used to pay medical expenses.

This controversial arrangement was used by plan sponsors as a means of reducing the rising cost of retiree medical expenses. However, this Ruling makes it clear that such arrangements do not achieve the desired result.

New Rules Require Shareholder Approval of All Equity Compensation Plans

The SEC has implemented new rules, effective June 30, 2003, requiring shareholders of publicly traded companies to approve equity compensation plans and grants of stock made outside of a formal plan. In the past, it was common for boards of directors to approve equity compensation plans without shareholder approval. Under the new rules, shareholder approval is required for material amendments to equity compensation plans, such as an increase in the number of shares available for issuance, the expansion of the types of awards offered and an expansion in the class of eligible participants. Qualified employee benefit plans, excess plans, awards made to induce employment, and arrangements in which participants pay fair market value for stock are exempt from the shareholder approval requirement. Existing plans are also exempt from the new rules, unless there is a material amendment to such plan.

District Court Refuses to Dismiss Claims Against Committee Members

The Massachusetts District Court refused to dismiss breach of fiduciary duty claims brought against plan sponsor officers and benefit committee members on the basis that an individual's role as a fiduciary is determined not by title or job description, but by the individual's exercise of discretion with respect to the plan. In Stein v. Smith, the plan document named the company as the plan's fiduciary. The defendants argued that they were not fiduciaries in their roles as officers and benefits committee members as they were not named fiduciaries and were only performing duties on behalf of the company, the true fiduciary. The court held that a specific title or designation does not strictly define who is a plan fiduciary, and reasoned that the true measure of a whether an officer or committee member is a plan fiduciary is whether such individual exercised discretion with respect to the plan.

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