ROBINSON & COLE LLP
Employee Benefits & Compensation

IRS Releases Guidance on HSAs

In Notice 2004-50, the IRS released its last round of promised guidance on Health Savings Accounts ("HSAs"). As previously reported, HSAs were created in last year's Medicare Prescription Drug Act and permit individuals to establish tax-free accounts to help pay for medical expenses in connection with participation in high-deductible health plans ("HDHPs"). Generally, individuals must participate in an HDHP and have no other health coverage in order to participate in an HSA.

Among other provisions, this guidance clarifies that individuals who participate in a disease management program, wellness program, or employee assistance program ("EAP") will still be eligible to participate in an HSA, as long as such programs don't provide significant benefits in the nature of medical care or treatment. As an example, the guidance addresses most EAP arrangements—those that simply provide free or low-cost short term counseling and referral to an outside organization when necessary. These programs, according to the IRS, do not otherwise prevent individuals from establishing and contributing to an HSA. The guidance also permits individuals to participate in wellness programs that provide a wide-range of education and fitness services designed to improve overall health and prevent illness without jeopardizing eligibility for an HSA. In addition, it permits individuals to participate in disease management programs that typically include monitoring laboratory or other test results, contacting patients by telephone or using web-based reminders for health appointments and schedules, and providing information to minimize health risks without otherwise affecting an individual's participation in an HSA.

The IRS also clarified that an individual who is eligible for, but not actually enrolled in, Medicare may continue to contribute to an HSA (including making catch-up contributions) until the time Medicare coverage actually begins. Additionally, individuals eligible for medical benefits from the Department of Veterans Affairs, but who have not actually received such benefits during the previous three months may participate in an HSA.

In addition, the guidance revisited the issue of preventative care. In prior guidance, the IRS stated that preventative care services or screenings may be eligible for first-dollar coverage (not subject to the deductible) without adversely impacting an individual's ability to participate in an HSA, as long as the preventative care did not generally include benefits to treat an existing illness, injury, or condition. In this Notice, the IRS permits treatment that is incidental to a preventative care service or screening to be subject to first-dollar coverage without otherwise disqualifying an individual from participating in an HSA. For example, the notice stated that the removal of polyps during a diagnostic colonoscopy is preventative care that can be provided without regard to the plan's deductible and such service will not impact HSA eligibility.

Other issues addressed include mistaken contributions to an HSA, the use of specific disease policies in connection with an HSA, fees to trustees or custodians, when rollover contributions may be made, and comparability requirements for employer contributions.

While stating that Notice 2004-50 would be the final word on HSAs for the time being, the IRS did issue one substantive change to this guidance on August 9. Despite previously limiting HSA trustees and custodians to life insurance companies and banks without IRS approval, the IRS revised this policy and stated that any insurance company or bank already approved to be a trustee or custodian of an IRA or Archer Medical Savings Account is automatically approved to be an HSA trustee or custodian, and other persons may request approval from the IRS to serve in such capacity.

IRS Issues Final Regulations on Deemed IRAs

Since 2003, plan sponsors have been permitted to include deemed IRAs in qualified plans, providing a mechanism for employees to make voluntary contributions to a separate IRA within a qualified plan. The IRS has released final regulations providing guidance to employers that offer deemed IRAs within a qualified plan. Under the final regulations, if a deemed IRA is offered under a qualified plan, the plan and the IRA will be treated as separate tax entities, each subject to applicable rules. The proposed regulations required that a trust holding deemed IRA assets must be separate from a qualified plan trust. As a result of comments received on this provision of the proposed regulations, the IRS has removed the separate trust requirement. Under the final rules, a separate trust is not required for the IRA if the plan sponsor maintains a trust for the qualified plan; however, separate accounting is required to ensure compliance with the IRA rules. The elimination of the separate trust requirement is not as attractive as it could have been due to another change from the proposed regulations. That is, if either the qualified plan portion or the deemed IRA portion fails to satisfy any applicable qualification rule, the other component will also be disqualified unless the deemed IRA portion and the qualified plan portion are maintained as separate trusts.

As a result of this new guidance, more employers may be willing to offer deemed IRAs under their qualified plans. A plan sponsor that amends its plan to permit deemed IRAs should take into consideration the guidance provided under these regulations.

Tax-Exempt Organizations Targeted by IRS

The IRS has announced that it is launching a new enforcement effort relating to excessive compensation practices of tax-exempt organizations. The IRS will be seeking information from nearly 2,000 organizations regarding insider transactions, such as loans and the sale and lease of property to officers and others, as well as compensation and excess benefit transactions. The enforcement effort will be implemented through the use of Form 990 inquiries, as well as letters requesting specific information.

Taxation of Disability Benefit Payments Clarified by IRS

The IRS has issued a Revenue Ruling addressing the income tax consequences of short-term and long-term disability benefits received by employees. Whether or not disability benefit payments are includable in an employee's income depends on whether or not the employer contributions used to fund the disability plan have been included in the employee's income. If the employer contributions used to fund the plan have not been included in an employee's income, any disability benefit paid from such a plan will be included in the employee's income. However, if the employer contributions have been included in an employee's income, any disability benefit payments subsequently received will not be included in an employee's income.

The Ruling states that employers can permit employees to make an annual irrevocable election indicating whether or not to be immediately taxed on the employer contributions for the cost of coverage. If an employee elects to be taxed currently on the amount of premiums paid by the employer, the premiums will be reported on the employee's Form W-2 for that year and any disability benefits subsequently received by the employee will not be included in the employee's gross income. An employee who elects to have the premium excluded from gross income for that year will be taxed on any disability benefit payments subsequently received.

Employers can allow annual elections and also can permit employees to continue with their prior election unless affirmatively changed before the beginning of a new plan year. Employers who want to permit employees to make such an election should have their plan and employee communications updated to reflect the new rule.

Plan Sponsor May Not be Able to Correct Overstated Pension Estimates That Were Relied Upon by Retirees

A District Court in New York has given three retirees the opportunity to prove that their employer fraudulently induced them to retire by providing them with incorrect pension estimates. In the case, DePace v. Matsushita Electric Corporation, three employees were employed by Panafax Corporation, which was acquired in April, 1989 by Matsushita Electric Corporation. Matsushita offered a voluntary resignation program and provided the employees with pension benefit estimates. After the employees elected to participate in the program, they were informed that their pensions would be 12% to 36% less than the amount of the pension estimate that was previously communicated to them. In preparing the estimates, Matsushita's Assistant Manager for Financial Benefits, rather than an actuary, prepared the estimates based on the employees' date of hire with Panafax, instead of April 1, 1989, the date that Panafax merged with Matsushita. Although the pension estimates provided to the employees stated that the estimates were subject to correction for any errors in data accumulation or benefit calculations, the court found that this caveat did not protect Matsushita when the entire basis for calculating their benefits was affected by the error.

The employees made a claim of equitable estoppel under ERISA, seeking to prevent the reduction in their pension payments. In order to succeed in such a claim, the employees are required to prove at trial that they relied upon a material misrepresentation, the damages resulting from the misrepresentation, and extraordinary circumstances. The District Court found that the employees should be permitted to establish these facts at trial, stating that a jury could reasonably conclude that Matsushita acted recklessly in providing the incorrect estimates and knew that the representations made in the pension estimates would very likely be relied upon by employees.

This case highlights the importance of using reasonable procedures to provide participants with the most accurate pension benefit estimates possible in order to enable them to make informed decisions regarding their retirement benefits.

Company May Have Breached its Fiduciary Duty in Failing to Disclose Non-Public Information to Participants who Invested in Company Stock

In the case of In re AEP ERISA Litigation, AEP's 401(k) plan participants sued their employer and some of the company's directors claiming that they had breached their fiduciary duty in offering AEP stock as an investment option under the 401(k) plan when they knew it was an imprudent investment. The participants also alleged that AEP negligently misrepresented information and failed to disclose material information about AEP stock which the participants needed in order to make informed investment decisions regarding their 401(k) plan accounts.

AEP attempted to have the lawsuit dismissed claiming that it would have violated insider trading rules by disclosing non-public information about the company to plan participants. The court rejected AEP's position and allowed the participants the opportunity to establish their claims at trial. This is consistent with other cases where courts have found that ERISA's disclosure requirements do not run afoul of the insider trading rules.