For Your Benefit

Fox Rothschild LLP
ATTORNEYS AT LAW

A newsletter on current legal issues impacting employee benefits and executive compensation

DECEMBER 2012

IRS Eases Rules for Hurricane Sandy Relief

By Susan Foreman Jordan

On November 16, 2012, the IRS issued Announcement 2012-44 to liberalize the rules for loans and hardship withdrawals from qualified retirement plans to taxpayers affected by Hurricane Sandy. The special relief will apply to loans and distributions made between October 26, 2012, and February 1, 2013.

Eligibility

Those participants eligible for this special relief are active and former employees whose principal residence or place of employment on October 26, 2012, was within the federally-declared disaster area. The relief also extends to participants who have a parent, grandparent, child, grandchild, dependent or spouse who had a principal residence or place of employment within the disaster area on that date.

The liberalized hardship withdrawal rules extend only to those plans that, by law, may provide for hardship distributions. This would include 5401(k) plans, 403(b) plans, and governmental 457(b) plans, but not pension plans.

Relaxed hardship requirements

By regulation, hardship withdrawals normally are limited to a list of enumerated financial hardships, and participants are prohibited from making additional deferral contributions for a period of six months following receipt of a hardship withdrawal. However, plans are relieved of these constraints with respect to hardship distributions made under the Announcement. The relief is provided for *any* hardship of the employee, and no post-distribution contribution restrictions are imposed.

Extended compliance period

Loans and hardships emergency distributions may be made during the relief period even if the plan does not then include appropriate provisions. Such a plan must be amended to add the necessary provisions, but the amendment will be considered timely as long as it is adopted by the end of the first plan year beginning after December 31, 2012.

In addition, the IRS will not treat a plan as failing to follow its terms because a loan or distribution is made to a participant eligible for relief without complying with the procedural requirements specified by the plan. The guidance requires only that the plan administrator make what, under the circumstances, is a "good faith diligent effort" to secure the normal documentation as soon as practical after the loan or distribution has been made.

Apart from the relaxed procedural and documentation requirements, all of the normal terms and conditions (amount, duration, interest rate, etc.) apply to loans. The participants who receive hardship or emergency distributions will be subject to the normal tax consequences associated with those disbursements. These include ordinary income taxes and, when applicable, the 10 percent early distribution excise tax.

A parallel announcement issued by the Department of Labor on November 20, 2012, grants relief from certain failures that otherwise might be deemed to be a fiduciary breach or prohibited transaction. These include failures to timely deposit 401(k) deferrals, provided that the failure is attributable to Hurricane Sandy and that the failure is remedied as soon as practicable under the circumstances.

For more information regarding about this topic, please contact Susan Foreman Jordan at 412.391.1334 or sjordan@foxrothschild.com, or any member of the Fox Rothschild LLP Employee Benefits and Compensation Planning Practice Group.

In This Issue:

Author

Susan Foreman Jordan
412.394.5543
sjordan@foxrothschild.com

Qualifying Plans Down on the Hacienda (Puerto Rico)

By Mark H. Hess and Jeremy Pelphrey

Sponsors of tax-qualified retirement plans that have employees resident in Puerto Rico or employees that received Puerto Rico source contributions should be aware that Puerto Rico has its own system for qualifying retirement plans. While the provisions in Puerto Rico's tax code relating to qualified plans are similar to those in the Internal Revenue Code, there are a number of important distinctions. Typically, if the sponsor of a retirement plan qualified in the United States wishes to have its plan qualified in Puerto Rico, an addendum to the plan needs to be prepared that outlines the different rules that will apply to Puerto Rican participants. An alternative approach to compliance is to have the plan sponsor adopt a separate plan covering its Puerto Rican employees. A determination request must be filed with the Hacienda, Puerto Rico's Department of Treasury, which, like the IRS, will work with the plan sponsor to issue a favorable determination on the qualified status of the plan if the addendum is prepared in a manner satisfactory to the Hacienda. Unlike the federal income tax rules, however, a retirement plan cannot be a qualified plan unless it is filed with and receives the approval of the Hacienda.

Under Puerto Rico's tax code, one lone Puerto Rican participant (either a Puerto Rican resident who accrues benefits or gets a distribution under the plan or a U.S. resident who accrued benefits under the plan based on compensation earned in Puerto Rico) is enough to trigger the requirement to have the plan become Puerto Rico-compliant. Puerto Rican authorities have adopted a program to assist employers who were not aware of the separate qualification requirement under Puerto Rican law: If an employer's U.S. tax qualified retirement plan is amended by December 31, 2012, to include the provisions applicable to Puerto Rican participants, and if a determination request with respect to the plan is filed with the Hacienda by April 15, 2013, (or any later extended return filing due date), the Hacienda will not pursue the employer for failing to comply with Puerto Rican law prior to 2013. While a further extension of these due dates was recently announced, we are not certain that relying on the extension will provide the same level of protection for prior years. Accordingly, we recommend that employers that have decided to amend their plans to comply with Puerto Rico laws adhere to the original December 31, 2012, and April 15, 2013, deadlines.

If a plan that has Puerto Rican participants is not qualified under Puerto Rican law, it is treated as a nonqualified plan of deferred compensation for Puerto Rican participants. This means that Puerto Rican participants would be taxed when contributions to the plan made on their behalf are no longer subject to a substantial risk of forfeiture. It also means that earnings on vested accounts would be taxable to Puerto Rican participants. Finally, it means that the plan sponsor making the contributions will not be able to deduct the contributions until they are treated as income to the Puerto Rican participant. Since in most cases it will be fairly easy to create a plan addendum and to file a determination request with the Hacienda, we recommend that any employer that has Puerto Rican plan participants take the steps necessary to qualify the plan under Puerto Rican law. Life in the Hacienda is changing – affected employers need to adapt.

For more information regarding this topic, please contact Mark H. Hess at 310.598.4152 or mhess@foxrothschild.com, Jeremy Pelphrey at (310) 598-4166 or jpelphrey@foxrothschild.com or any member of the Fox Rothschild LLP Employee Benefits and Compensation Planning Practice Group.

Authors

Mark H. Hess
310.598.4152
mhess@foxrothschild.com

Jeremy M. Pelphrey
310.598.4166
jpelphrey@foxrothschild.com

Alternative Investments by Retirement Plans

By Harvey M. Katz

In the current investment climate involving historically low interest rates and an uncertain stock market, we have been approached by clients, consultants and third party administrators with the same request: "Can a plan invest in non-traditional investments, such as real estate?" The short answer is yes, as long as one follows the rules. Needless to say, there are numerous rules that must be followed. This article presents an overview of the pertinent considerations.

Prohibited Transactions

Prohibited transactions come in two flavors: (1) outright prohibitions; and (2) more nebulous prohibitions involving self-dealing and conflicts of interest. There are absolute prohibitions against the plan from dealing with a party-in-interest (i.e. any person or entity with a relationship with the plan such as its sponsoring employer and the owner of the employer). Practically, this prohibits the plan from purchasing an investment from its sponsor no matter how attractive the investment. Self-dealing prohibitions are more nebulous. For example, a plan may not participate in an investment with one made by a related party for the primary purpose of achieving a minimum threshold investment. However, if the plan can independently justify the prudency of the investment, it may be permitted.

General Fiduciary Considerations

Under ERISA, plan trustees are required to invest prudently and to diversify investments unless clearly prudent not to do so. Accordingly, it is critical that trustees carefully document their analysis of the investments chosen. Gut feelings and overall business acumen are no substitute for a carefully documented file. In the alternative, the fiduciary rules may be avoided in plans covering only an owner and his or her spouse and via utilization of self-directed accounts.

Potential Discrimination Issues

When seeking to avoid the fiduciary considerations through use of self-directed accounts, certain IRS discrimination rules come into play. In general, tax-qualified plans such as 401(k) plans may not make "benefits, rights and features" available to highly paid employees that are not available to the rank and file employees. Thus, participants should not be denied the opportunity to participate in an attractive investment. On the other hand, more speculative investments favored by owners and the more highly compensated are not necessarily appropriate for rank and file employees and those participants should not be forced or encouraged to invest in any investment that does not pass fiduciary muster.

General Tax issues

Plan sponsors need to be mindful of the interplay between the tax attributes of qualified plans and the lower capital gains rates available on the gain from the sale of real estate. While the income and gains from sale of assets are generally not taxed on assets held by a pension plan, (see discussion of unrelated business taxable income, below) the proceeds are eventually taxed at ordinary income rates when distributed from the plan. While the deferral of tax is a valuable benefit, plan sponsors need to be mindful of the disparity in tax rates. In addition, the depreciation deductions generally available for the owner of real estate are not available to a tax-exempt retirement plan. However, the losses can be used to reduce the amount of any unrelated business taxable income generated.

Unrelated Business Taxable Income

Unrelated Business Taxable Income comes in several varieties. It comes into play when a tax-exempt entity, such as a retirement plan, operates an active business and the income attributable to those business operations becomes taxable. In general, this rule does not apply to passive investments like real estate. However, when the plan takes a loan to purchase the property, the portion of the income attributable to the financing becomes taxable.

Audit, Valuation and Increased Bonding Requirements

Most plans investing more than 5 percent of their assets in anything other than publicly and other widely traded investments ("qualifying" assets), are required to obtain audited financial statements. For plans with less than 100 participants, the auditing requirement can be avoided by raising the amount of the required bond from 10 percent of the value of the plan assets to 100 percent of the "non-qualifying" plan assets. In any event, each year plan trustees are required to make a good faith estimate of the fair market value of each asset held by the plan. When rank and file participants share in the investment, best practices

require that an independent third party valuation be obtained.

Practical Considerations

While it may seem obvious, plan sponsors are cautioned that all assets owned by the plan, including real estate, must be held by the plan and not in the name of the sponsoring employer or its owner. Similarly, any insurance maintained on the property/real estate should be in the name of the plan. Any mortgage on the property/real estate should be in the name of the plan. Personal guarantees of the mortgage by a related party could be a prohibited transaction unless properly structured.

Conclusion

Undoubtedly, the amount and complexity of the requirements will discourage some plan sponsors. However, under the right circumstances and with the correct guidance, alternative investments are not only doable but represent highly attractive options for many retirement plans.

For more information regarding this topic, please contact Harvey M. Katz at 212.878.7976 or hkatz@foxrothschild.com or any member of the Fox Rothschild LLP Employee Benefits and Compensation Planning Practice Group.

Author

Harvey M. Katz
212.878.7976
hkatz@foxrothschild.com

HHS Issues Proposed Regulations on Wellness Programs

By Keith R. McMurdy

Earlier this month, HHS issued new proposed regulations on wellness programs. These proposed regulations are designed to comply with the provisions of PPACA dealing with wellness programs. Again, these are proposed regulations and are not final yet, but they provide some insight into what will ultimately be the rules for wellness programs going forward.

The proposed regulations would apply to plan years beginning on or after January 1, 2014, and do not significantly change the 2006 regulations previously issued. Some key points to be aware of:

1. The maximum allowed reward for "standards-based" programs increases to 30 percent of the cost of coverage;
2. The maximum allowed reward for programs designed to prevent or reduce tobacco use is 50 percent;
3. Reasonable alternatives for rewards must be provided to account for medical conditions (or conditions where it is medically inadvisable to attempt compliance); and
4. Plans and insurers may seek verification of claims for medical exemptions (unless the condition is obvious or known to the plan or insurer already).

The proposed regulations also include sample language on how to provide notice of opportunities to obtain rewards and how to request the alternative from the plan.

For the most part, the proposed regulations seem to be focused primarily on clarifying certain provisions of the 2006 regulations relating to non-discrimination and options to obtain rewards and benefits as part of an accommodation or exception. While these are not final yet, sponsors of wellness programs would be wise to review their plans to make sure that they offer appropriate alternatives in both their standards-based and participation-based programs.

For more information regarding this topic, please contact Keith McMurdy at 212.878.7919 or kmcmurdy@foxrothschild.com or any member of the Fox Rothschild LLP Employee Benefits and Compensation Planning Practice Group.

Author

Keith R. McMurdy
212.878.7919
kmcmurdy@foxrothschild.com

New Limit on Health Flexible Spending About to Take Effect

By Susan Foreman Jordan

Among the many changes made by the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 is the imposition of a statutory limit on the amount of salary reduction contributions that may be made by employees to a health flexible spending or medical expense reimbursement account. The new limit of $2,500 applies to *taxable years* beginning on or after January 1, 2013, and the amount will be indexed for cost-of-living adjustments in future years.

For this purpose, "taxable year" means the plan year of the Section 125 cafeteria plan and the period for which salary reduction elections are made. So, if a cafeteria plan has a July 1 - June 30 plan year, the new limitation will become effective as of July 1, 2013. Initially, there was some confusion as to how the restriction would apply to non-calendar year plans. However, the IRS provided clarification earlier this year in the form of Notice 2012-40.

The Notice also confirms that the $2,500 cap applies on an employee-by-employee basis. If both spouses are participants in the same flexible spending arrangement, each may elect to make a salary reduction contribution of up to $2,500. Moreover, the limit applies only to salary reduction contributions and not to any employer provided contributions or credits.

Obviously, the new $2,500 limit will necessitate amendment of any plan or program that previously permitted salary reduction contributions in excess of that amount. Although the date by which the amendment must be adopted has been extended through the end of calendar year 2014, employers are urged to act more quickly so as to avoid errors and misunderstanding among participants.

For more information regarding about this topic, please contact Susan Foreman Jordan at 412-391-1334 or sjordan@foxrothschild.com, or any member of the Fox Rothschild LLP Employee Benefits and Compensation Planning Practice Group.

Author

Susan Foreman Jordan
412.394.5543
sjordan@foxrothschild.com

Fox Rothschild LLP
ATTORNEYS AT LAW

Are You Reading Fox Rothschild's Employee Benefits Legal Blog?

If you are a professional who actively participates in the administration of plans and has questions regarding the current state of the law and the interaction of the law with human resource obligations, we invite you to read our Employee Benefits Legal Blog. Our postings are written with an eye toward topics salient to the administration of employee benefit programs in conjunction with employment concerns. We know how essential it is for you to keep current on the changes in the law (and, in some instances, case decisions) that directly impact benefits plan administration - including the ever-changing "reasonable person" standard under ERISA. We offer the latest updates and commentary on the interaction between employee benefits and human resources. View Blog

For Your Benefit is available online at
www.foxrothschild.com.