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EMPLOYEE BENEFITS DEVELOPMENTS APRIL 2014

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Employee Benefits

Supreme Court Holds Severance Payments Are Subject to FICA Taxes

Reversing a decision by the Sixth Circuit Court of Appeals, the U.S. Supreme Court ruled unanimously that severance payments to employees who were involuntarily terminated as part of a Chapter 11 bankruptcy were taxable wages subject to Social Security and Medicare (FICA) taxes. The decision disappointed many who had hoped the court would uphold the earlier appeals court ruling that certain severance payments should be exempt from FICA taxes as supplemental unemployment compensation benefits (SUBs).

Entering bankruptcy proceedings in 2001, Quality Stores, Inc. terminated thousands of employees as part of a reduction in work force or discontinuance of a plant or operation. Quality provided them with severance payments under two different termination plans. The company reported the severance as W-2 wages, paying the employer's share of FICA taxes and withholding the employees' share of FICA taxes on the severance. On behalf of itself and about 1,850 former employees, Quality then filed for a refund of over $1 million in FICA taxes. When the IRS declined to rule on the claim, Quality sought a refund of the disputed amount through the bankruptcy court. The bankruptcy court granted summary judgment in favor of Quality, a decision that was later affirmed by a district court and the Sixth Circuit. All concluded that severance payments are not "wages" under FICA.

Following the Sixth Circuit decision, numerous companies filed protective refund claims for FICA taxes incurred on severance payments made as part of a workforce reduction, hoping for a favorable ruling by the high court that would require the IRS to provide refunds on their FICA tax payments. In denying the FICA tax exemption, the Supreme Court focused on the nature of severance, noting that severance payments made to terminated employees are "remuneration for employment." Moreover, the severance payments in this case varied based on job

seniority and time served and were not linked to the receipt of state unemployment benefits. Discussing the historical treatment by the IRS of SUB and severance payments, the court rejected Quality's argument that the tax code mandates that severance payments are to be deemed wages for purposes of income-tax withholding but are not subject to FICA taxation. Opinions vary on the larger effects of the decision, especially with respect to severance payments tied to state unemployment benefits, but Quality and its former employees will receive no refund from the IRS on the FICA taxes paid on their severance. (*United States v. Quality Stores, Inc.*, U.S. 2014)

Court Holds Georgia Law Pre-Empted by ERISA

The U.S. Court of Appeals for the Eleventh Circuit held that a Georgia law requiring self-insured health plans to pay benefit claims within 15 business days was preempted by ERISA. In 2011, the State of Georgia enacted a law amending portions of Georgia's insurance code, including Georgia's "prompt pay" laws. These prompt pay laws had been put in place in 1999 and required insurers to either pay or deny a benefit claim within 15 working days. As originally enacted, self-insured health plans subject to ERISA were expressly excluded. However, because more employers were trending from insured plans to self-insured plans in recent years, Georgia sought to amend the prompt pay laws to include self-insured plans. This expansion of the prompt pay laws to include self-insured plans was scheduled to become effective January 1, 2013. Before the expansion of the law became effective, however, America's Health Insurance Plans (AHIP) filed an action for declaratory judgment against Georgia's Insurance and Safety Fire Commissioner from enforcing these provisions. A district court granted AHIP's motion and preliminarily enjoined the commissioner from enforcing the expanded law on the grounds that the expansion was preempted by ERISA. In upholding the lower court's decision, the Court of Appeals stated that the Georgia law impermissibly encroached on federal law. (*Am.'s Health Ins. Plans v. Hudgens*, 11th Cir., 2014)

Vermont Cannot Require ERISA Plans to Report Claims Data

In October 2011, the State of Vermont enacted a statute requiring the establishment and maintenance of a unified health care database designed to enable Vermont to evaluate, among other things, the effectiveness of health care, compare health care costs, provide information to consumers and purchasers of health care, and improve the quality and affordability of health care and health care coverage. Under the law, health insurers are required to provide Vermont with enrollment and claims information and other information relating to health care costs, prices, quality, utilization, and resources. The term "health insurer" is defined broadly to include third-party administrators and pharmacy benefit managers, including administrators of self-insured benefit plans. A Vermont regulation specifies how this information must be recorded and transmitted.

Liberty Mutual, an insurance company with offices in Vermont, maintains a self-insured ERISA welfare plan for the benefit of its employees. In August 2011, Vermont issued a subpoena demanding that the third-party administrator of the plan supply the state with eligibility files, medical claim files, and pharmacy claim files for Vermont residents covered by the plan. Liberty Mutual instructed its third-party administrator not to comply and sued Vermont in the U.S. District Court for the District of Vermont to enjoin enforcement of the subpoena on the grounds that ERISA preempted Vermont's statute and regulation. The district court ruled against Liberty Mutual, holding that the law was not preempted because the law doesn't alter the way ERISA plans process and adjudicate claims, pay benefits, or make administrative decisions. Liberty

Mutual appealed the decision to the Second Circuit Court of Appeals, which overruled the district court, finding that the Vermont law is preempted by ERISA. According to the court, "ERISA preemption does not allow one of ERISA's core functions – reporting – to be laden with burdens, subjected to incompatible, multiple, and variable demands, and freighted with risk of fines, breach of duty, and legal expense."

This decision has New York, Connecticut, and Vermont plan sponsors and third-party administrators breathing a sigh of relief. With ACA reporting obligations bearing down on employers and plans, imagine the pain and suffering that would come from having to comply with the laws of any state that chooses to enact a statute like the one in Vermont. In a broadly worded opinion, the Second Circuit has emphasized the principle that ERISA plans cannot be required to comply with state laws that conflict with ERISA and impose burdensome obligations on the operation of ERISA plans. (*Liberty Mut. Ins. Co. v. Donegan*, 2d Cir.)

No Harm, But Possible Equitable Remedy in Case

Following the Supreme Court's decision in *Cigna v. Amara* in 2011, there have been many decisions trying to outline what remedies are available for violations of ERISA. These decisions have led employee benefit lawyers to review many old rules of law to determine what are "equitable remedies," concepts that many benefit lawyers have ignored since the days of law school and bar exams.

A recent decision by the Second Circuit Court of Appeals deals with the scope of available equitable remedies under ERISA. The case involves Foot Locker's conversion of its traditional defined benefit plan to a cash balance plan in 1996. A long-term participant withdrew his pension benefits in 2002 and filed a class-action lawsuit claiming the conversion and other actions violated many requirements of ERISA. Over time, many of the claims made by the former participant were dismissed. Some of the remaining claims included a request for equitable relief by surcharge and contract reformation. The district court held that entitlement to equitable relief in these situations required a showing of actual harm by the former participant. The district court found that the former participant's damages were speculative and dismissed these claims on that basis. An appeal was taken to the Second Circuit.

The Second Circuit held that the level of harm that had to be shown in order to make a valid claim for equitable relief depended on the type of equitable relief sought. The claim for contract reformation would require Foot Locker to amend their plan documents in certain ways. Foot Locker did not argue at the appeal level that the former participant was not entitled to bring a claim for contract reformation because he did not suffer actual harm. Rather, Foot Locker argued that contract reformation was not available as a remedy because the former participant was no longer an active participant and would not benefit by any amendments made to the plan document and the former participant could not show fraud or mutual mistake, an element for contract reformation. The Second Circuit ruled that the former participant was not required to show actual harm for contract reformation and reversed the district court decision on this point and remanded the case to the district court to find whether the participant had proper standing to bring a claim for contract reformation. Because contract reformation could give the former participant total relief, the Second Circuit declined to rule on the issue of whether actual harm is a necessary element to a surcharge claim. (*Osberg v. Foot Locker, Inc.*, 2d Cir., 2014)

RULINGS, OPINIONS, ETC.

IRS Issues Guidance on Application of *Windsor* Decision to Qualified Retirement Plans

Following the Supreme Court's decision in *Windsor* that Section 3 of the Defense of Marriage Act (DOMA) is unconstitutional, the Internal Revenue Service (IRS) issued Revenue Ruling 2013-17. In Revenue Ruling 2013-17, the IRS held that a marriage between same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex would be recognized for federal tax purposes, even if the married couple became domiciled in a state that does not recognize the validity of same-sex marriages (See ourOctober 2013 newsletter for additional discussion of Revenue Ruling 2013-17). One of the open questions following the *Windsor* decision and Revenue Ruling 2013-17 was whether the *Windsor* decision would be applied retroactively to qualified retirement plans.

In the form of nine questions and answers, the IRS recently issued guidance answering that the *Windsor* decision would not be applied retroactively to qualified retirement plans. Accordingly, a qualified retirement plan will not be treated as having failed to meet the requirements of Section 401(a) of the Internal Revenue Code merely because it did not recognize a participant's same-sex spouse as his or her spouse prior to June 26, 2013 (i.e., the date of the*Windsor* decision). Moreover, if during the period following the *Windsor* decision but prior to the effective date of Revenue Ruling 2013-17 on September 16, 2013, a qualified retirement plan recognized a participant's same-sex spouse as his or her spouse only if the participant was domiciled in a state that recognized same-sex marriages, a qualified retirement plan will not be treated as having failed to meet the requirements of Code Section 401(a) merely because the plan was not operated in accordance with the state of celebration rule announced in Revenue Ruling 2013-17 during this window period.

To the extent a qualified retirement plan's terms are inconsistent with the*Windsor* decision, the plan must be amended. For many plans, the deadline to adopt a plan amendment is December 31, 2014. As described above, though, a qualified retirement plan must have been operated in accordance with the*Windsor* decision as of June 26, 2013. In the case of a single-employer defined benefit plan, a plan amendment required to comply with the *Windsor* decision will not be treated as impermissibly increasing the plan's liability for benefits in violation of Code Section 436.

A plan sponsor may elect to apply the *Windsor* decision for periods prior to June 26, 2013. If a plan sponsor makes such an election, a plan amendment is required to specify the date as of which (and for which purposes) the *Windsor*decision will be applied. Any discretionary plan amendment must comply with applicable qualification requirements, including the nondiscrimination rules. The deadline for any plan amendment would again generally be December 31, 2014. However, unlike a required plan amendment to reflect the *Windsor* decision, any discretionary amendment to a single-employer defined benefit plan must comply with Code Section 436's restrictions on plan amendments increasing a plan's liability for benefits.

The IRS guidance does not address whether the *Windsor* decision applies retroactively for purposes of ERISA. Thus, it remains unclear, for example, whether a same-sex spouse may have standing to bring a claim for benefits under a retirement plan subject to ERISA where the spousal consent rules were disregarded in accordance with DOMA.

Action Steps. Plan sponsors should review their qualified retirement plan documents to determine whether a plan amendment to reflect the *Windsor*decision is required and, if an amendment is required, amend the plan. Plan sponsors considering a discretionary amendment to make the *Windsor* decision applicable for periods prior to June 26, 2013, should carefully weigh the consequences of making such an amendment. Further, to the extent plan administrators have not already done so, they may wish to consider notifying participants of the *Windsor* decision and request that any affected participants review and update their beneficiary designations. (IRS Notice 2014-19)

IRAs to Be Subject to Stricter Rollover Limitations

A rollover from one individual retirement account (IRA) to another IRA is permitted only once during any 12-month period beginning with the day funds are received from the first IRA. This rule is sometimes called the "one-year look-back rollover limitation." The IRS's position for many years, as reflected in proposed regulations and IRS Publication 590, is that the one-year look-back rollover limitation may be applied separately by a taxpayer to each of the taxpayer's IRAs. But, in the wake of the tax court's recent opinion in *Bobrow v. Commissioner* (T.C. Memo. 2014-21), the IRS position with respect to the one-year look-back rollover limitation is changing. In *Bobrow*, the tax court held that the one-year look-back rollover limitation applies on an aggregate basis, meaning that an individual cannot make an IRA-to-IRA rollover if he or she made such a rollover involving any of the individual's IRAs in the preceding one-year period.

In response to the *Bobrow* decision, the IRS recently announced it anticipates following the tax court's interpretation of the one-year look-back rollover limitation, and will begin to enforce the one-year look-back rollover limitation on a taxpayer-by-taxpayer basis and not on an IRA-by-IRA basis. Beginning as early as January 1, 2015, a taxpayer will be permitted to make only one rollover from a traditional IRA to another (or the same) traditional IRA in any 12-month period, regardless of the number of IRAs the taxpayer owns. Because the adoption of the*Bobrow* interpretation of the one-year look-back rollover limitation will require IRA trustees to make changes to their IRA rollover procedures and disclosures that will take time to implement, the IRS will not apply the *Bobrow* interpretation to any rollover of an IRA distribution occurring before January 1, 2015. A similar limitation will apply to rollovers between Roth IRAs. Taxpayers, however, may continue to make as many trustee-to-trustee transfers between IRAs as desired. (IRS Announcement 2014-15)

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