



COBRA Audits – Another Worry for Employers

By Susan Foreman Jordan

In March of this year, the Internal Revenue Service published a guide to be used by its examiners in monitoring compliance by employers and group health plan sponsors with the requirements under the Consolidated Omnibus Budget Reconciliation Act (COBRA). In the recent past, it has been the Department of Labor that has been more active in enforcement of the rules for healthcare continuation coverage, but it is feared that the release of these guidelines may signal yet another new IRS audit initiative, for which employers should be prepared.

COBRA was enacted in 1985 to give *covered employees* (those covered under an employer-sponsored group health plan) and their families who otherwise would lose coverage as a result of a *qualifying event* the right to continue coverage under that plan at their own expense. Among the qualifying events that may trigger these healthcare continuation rights are retirement, termination of employment (other

than by reason of gross misconduct), reduction in hours, death, or entitlement to Medicare benefits. Among the qualifying events that might affect family members identified as qualified beneficiaries are divorce or legal separation from the covered employee and loss of dependent child status. Generally, the coverage available under COBRA must be identical to that received immediately prior to the qualifying event.

In order to assure that covered employees and qualified beneficiaries are made aware of their rights to continuation of healthcare coverage, written notice of these rights must be provided to each covered employee and spouse at the time coverage under group health plan commences. The employer must notify the plan administrator within 30 days after the covered employee's death, termination, reduction in hours, or entitlement to Medicare, and each covered employee or qualified beneficiary must notify the plan administrator within 60 days of any divorce or legal separation or of a child ceasing to be a dependent. The plan administrator then is obligated to notify the qualified beneficiaries of their COBRA rights within 14 days after receiving notice of the qualifying event.

Failure to comply with the COBRA requirements may trigger an excise tax in an amount equal to \$100 per qualified beneficiary (but not more

than \$200 per family) for *each day* of the non-compliance period. Both the employer that maintains the plan and the plan administrator may be liable for the excise tax. Even when the failure is unintentional and due to reasonable cause, with no willful intent, excise taxes of up to \$500,000 may be imposed each year.

To monitor compliance, the examination guidelines suggest that the auditor request the following information:

1. A copy of the healthcare continuation coverage procedures manual;
2. Copies of standard healthcare continuation coverage form letters sent to qualified beneficiaries;
3. A copy of the taxpayer's internal audit procedures for healthcare continuation coverage;
4. Copies of all group healthcare plans (and, if necessary, compare the amount of healthcare expenses claimed on the employer's return as a deduction to confirm that all plans are listed), and
5. Details pertaining to any past or pending lawsuits filed against the employer for failure to provide appropriate continuation coverage.

Then, based on the procedures in place, the examiner is directed to probe specific areas for noncompliance and to interview responsible parties regarding the number of qualifying events occurring in the year under

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examination, the method by which qualified beneficiaries are notified of their rights to continuing healthcare coverage, the method by which the plan administrator is notified that a qualifying event has occurred, the election made by qualified beneficiaries, and the premium paid by qualified beneficiaries.

While the guide is intended for IRS

field auditors, it can serve as an internal checklist to be used by employers to assure that they will be prepared in the event of a COBRA audit.

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What To Do About Those Underfunded Defined Benefit Plans? Termination Is The Answer.

By Harvey M. Katz

It is all too common that employers sponsor underfunded defined benefits plans that they cannot afford to terminate. Because interest rates bear an inverse relationship to the value of participant benefits, there is little chance of improvement in the near future. Unfortunately, far too many employers fail to act decisively to terminate the plan until their financial condition deteriorates beyond repair.

Most employers are aware that underfunded defined benefit plans may not be terminated without the permission of the Pension Benefit Guaranty Corporation (PBGC). Under ERISA, such permission may be granted only in the following four situations:

- (1) *Liquidation.* The plan sponsor (and every member of its controlled group) is undergoing liquidation under Chapter 7 of the Bankruptcy Code, or equivalent state law proceeding.
- (2) *Reorganization.* The plan sponsor has filed a petition under Chapter 11 of the Bankruptcy Code, or similar state law proceeding, and the court determines that, unless the plan is terminated, the

sponsor is unable to pay all its debts and will be unable to continue in business outside the reorganization process unless the plan is terminated.

- (3) *Inability to continue in business.* The plan sponsor demonstrates to PBGC's satisfaction that, unless a *distress termination* occurs, the plan sponsor will not be able to pay its debts when due and to continue in business.
- (4) *Unreasonably burdensome pension costs.* The plan sponsor demonstrates to PBGC's satisfaction that the costs of providing pension coverage have become unreasonably burdensome solely as a result of declining covered employment under all of the sponsor's single-employer plans.

As bankruptcy is not an option for many plan sponsors of underfunded plans for a variety of reasons, most plan sponsors are left to focus on the last two criteria, as neither requires that the plan sponsor declare bankruptcy. Nevertheless, in many cases, the cost of maintaining the plan has become unreasonable. This most

often occurs when the plan sponsor is unable to make a required minimum funding contribution, which can often lead to substantial penalties. The IRS imposes an initial 10 percent excise tax on delinquent plan contributions and a 100 percent "second tier" excise tax if the contribution is not made after the 10 percent tax is assessed. Once the 10 percent excise tax is assessed, it is difficult, if not impossible, for many such employers to recover.

When the plan is unable to make a minimum funding contribution, or misses a quarterly contribution payment, it is imperative that the plan sponsor act quickly to prevent penalties, interest and excise taxes from snowballing out of control. In our experience, too many plan sponsors wait until it is too late to control these costs – to a point where bankruptcy is the only viable option. Once a plan sponsor is unable to meet minimum funding requirements, the only way to stop required contributions, interest and excise taxes from continuing to accumulate is termination of the plan.

Many plan sponsors (and pension professionals) incorrectly believe that the PBGC's termination criteria are too

narrow to permit plan termination outside of bankruptcy or believe that their financial situation is not dire enough so as to warrant termination. PBGC has the discretion to waive any requirement of the regulations to the extent it is in PBGC's interest to do so. In this author's experience, PBGC will accept a properly documented distress termination application that includes well-supported rationale for the termination.

Plan sponsors requesting PBGC approval of a distress termination must provide extensive information relating to the financial status of the both the plan and the plan sponsor. In requesting a distress termination, the plan sponsor must submit detailed and extensive information concerning the termination of the plan, including: (1) financial statements for five years; (2) minimum funding waivers approved by the IRS; (3) information concerning partial liquidation, of the plan sponsor; (4) complete footnote disclosures, for the financial statements; (5) business plans and projections, (6) recent financial

analyses of the plan sponsor prepared by a third party; and (7) certification by the chief executive officer that the entity will not be able to continue in business unless the plan is terminated.

In many cases, the financial information does not tell the entire story. Sponsors seeking approval for a distress termination with PBGC need to supplement the financial and demographic information with an appropriate narrative that objectively marshals the facts that supports the distress termination, without "overselling" their dire financial condition. This is where the services of a pension professional with experience in this area is critical, as such professionals are experienced with working through this process with PBGC and can draw on their experience as to the type and substance of information that best positions the plan sponsor with PBGC.

One item of good news for plan sponsors in difficult financial straits is that while the decision to terminate a plan is a "settlor" function, and the

professional advice in connection with that decision cannot be paid from the plan, the *implementation* of the decision to terminate is a cost of compliance which is generally payable from plan assets. Because the bulk of the costs, including the application to PBGC, will be incurred in the implementing the termination decision, such costs are generally payable from plan assets. Plan sponsors are well advised to seek the advice of experienced professionals early in the process.

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The Price of Fiduciary Failure – \$36.9 Million

By Theresa Borzelli

As reported in the February 2012 edition of *For Your Benefit* (see "The Final Fee Disclosure Rules Finally Arrive" by Daniel Kuperstein and Harvey Katz), the United States Department of Labor recently issued the final fee disclosure regulation to ERISA. The purpose of the regulation is to ensure that plan sponsors and fiduciaries of ERISA retirement plans have the fee information necessary to enable them to fulfill their obligations under ERISA of determining both the reasonableness of compensation paid for and the potential conflicts of

interest that may affect the performance of those services provided to a plan.

While the regulation does not go into effect until July 1, 2012, and the effects of the regulation (and its companion regulation under ERISA section 404(a)(5), which is effective August 30, 2012, that requires the plan administrator to provide certain fee disclosures to plan participants) may not be seen for several years, one recent case has cast a spotlight on what could be called the poster child for bad fiduciary behavior and

illustrates the consequences to plan fiduciaries who do not understand or take seriously their duties to plan participants.

In that case, *Tussey v. ABB, Inc.*, the Court found that the plan fiduciaries breached their duties to the plan participants of two 401(k) plans sponsored by ABB, Inc. and were jointly and severally liable for \$35.2 million in damages to the plan participants. In addition, the service providers were ordered to pay the plans \$1.7 million for lost float income.

In brief, the court found that the fiduciaries (both service providers were found to be fiduciaries to the plans) breached their duties to the plan participants by:

- (1) Failing to monitor recordkeeping fees paid through revenue sharing and cash payments;
 - (2) Failing to use the plans' size to negotiate rebates for the plans;
 - (3) Failing to prudently deliberate when de-selecting and selecting investments options;
 - (4) Failing to select less expensive share classes than those selected for inclusion in the 401(k) plans' investment options;
 - (5) Subsidizing corporate expenses through revenue sharing with the 401(k) plans; and
 - (6) Improperly utilizing float income.
- (2) Act only on behalf of the plan and its participants – leave your corporate hat on the shelf;
 - (3) Know the who, what, when and how much when paying for services to the plan;
 - (4) Benchmark the fees the plan is paying for investments;
 - (5) Monitor recordkeeping and other fees for the administration of the plan;
 - (6) Implement and follow written procedures for selecting/de-selecting an investment option;
 - (7) When available, choose less expensive share classes of the selected investment options;
 - (8) Seriously consider and investigate reports that the fees paid by the plan may be subsidizing corporate services;
 - (9) Consider having an independent advisor periodically review plan operations and administrative processes; and
 - (10) Document! Document! Document!

Although the list set forth above is a just a short summary of *Tussey* and its findings, at least 10 things fiduciaries should do can be gleaned from the case:

- (1) Understand and follow the terms of the plan's governing documents;

When navigating the new regulations and working through the regulatory compliance issues with respect to fee disclosure, we strongly recommend the use of experienced benefits counsel. Your Fox Rothschild benefits team is available to help you work through this minefield of fee disclosure regulations.

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FSA Cap Update – Limited Relief Announced

By Seth I. Corbin

At the end of May, the Internal Revenue Service issued some welcomed guidance on the 2013 cap on employee contributions to health care flexible spending accounts (FSAs).

The Affordable Care Act introduced a \$2,500 annual limit on employee contributions to FSAs beginning in taxable years on or after January 1, 2013. "Taxable years" was previously undefined, so prudent plan sponsors of non-calendar year plans amended such

plans to incorporate the \$2,500 limit beginning in the 2012-2013 plan year. However, the IRS' recent guidance indicates that such an approach is not necessary.

Specifically, IRS Notice 2012-40 provides relief for non-calendar year plans and makes it clear that the \$2,500 limit applies to plan years beginning on or after January 1, 2013. Unfortunately, Notice 2012-40 does not provide any relief for plans that

proactively amended to incorporate the limit for the 2012-2013 plan year.

In addition to the guidance regarding the limit's effective date, the IRS guidance also made it clear that plan sponsors have until the end of calendar year 2014 to amend their plan, although the cap applies beginning in 2013 regardless. Ordinarily, cafeteria plan amendments may only apply prospectively; however, Notice 2012-40 provides an

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exception to such rule as it relates to the maximum contribution amount.

Notice 2012-40 also raises the possibility that the “use-it-or-lose-it” rule may be eliminated or amended some time in the not too distant future. Although there is currently no change to the fact that unused FSA contributions do not carry over if unused from one plan year to the next, the IRS acknowledges that it is considering a change in light of the

\$2,500 contribution cap. A change to this rule would be well received by plan participants and help reduce the risk of loss associated with FSA contributions.

If you have not already done so, you should speak to your benefits counsel regarding your cafeteria plan and timely amending it to comply with the FSA limit on participant contributions beginning in 2013.

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