LEGISLATIVE AND REGULATORY UPDATE

PREPARED BY

PATRICK S. McELHONE, JD
PRINCIPAL
MERCER (US) INC.
1100 MEIDINGER TOWER
LOUISVILLE, KENTUCKY 40202

LOUISVILLE EMPLOYEE BENEFITS COUNCIL
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HHS publishes final regulations governing health insurance exchanges for 2014: Final regulations issued on March 12 outline standards for and functions of health insurance exchanges -- a key health care reform that many states are expected to offer in 2014. The final regulations encompass matters covered in separate sets of 2011 proposed rules, including certification of participating health plans, individual eligibility determinations and the Small Business Health Options Program. US Department of Health and Human Services (HHS) officials say the final rules give states flexibility to build and run exchanges. HHS will be accepting comments on a short list of related topics, including timeliness standards for eligibility decisions and transfers of data supporting premium tax credits and cost-sharing reductions. Press release on final exchange regulations (HHS, 12 Mar 2012); Fact sheet on exchange regulations (Healthcare.gov, 12 Mar 2012)

Senate OKs sponsor-friendly pension discount-rate stabilization, extends 420 transfers: Pension discount-rate stabilization reforms proposed by an employer coalition led by the American Benefits Council have passed the Senate -- with some modifications -- as part of highway legislation. The Senate-passed reforms offer significant short-term funding relief for 2012 and 2013, phasing down over five years. The bill also extends Section 420 transfers to retiree health accounts through 2021 and allows use of transferred funds toward retiree life insurance and health care benefits. Action now moves to the House, where the outlook is uncertain.

New 2011 version of Form 990 changes tax-exempts' governance and pay disclosures: The IRS has published the 2011 version of Form 990, "Return of Organization Exempt from Income Tax," and related schedules and instructions. Although the agency did not extensively alter sections dealing with governance and compensation, it did tweak several items. Changes include revised definitions of "reportable" and other compensation. And the form now requires tax-exempt organizations to describe the "terms and conditions" of severance, change-in-control and nonqualified retirement plans covering those individuals whose compensation must be disclosed in detail. This article highlights some of the more important modifications. Because the IRS, the press and others take an intense interest in governance and pay matters, filing organizations must be accurate and effective in relaying the information the form requires.

IRS publishes 2011 Form 990, schedules and instructions

The IRS has posted to its website Form 990 and related schedules and instructions for tax-exempt organizations' tax years beginning in 2011. The agency describes what it considers the 2011 "significant" changes in a "What's New" section on pages 1 and 2 of the form instructions. The 2008 version of the form reflected a major overhaul and, since then, the IRS has tweaked various items. Filing extensions are available, but, in general, Form 990 must be filed on or before the 15th day of the 5th month following the end of an organization's tax year (May 15th for a calendar-year organization).

This report highlights some of the 2011 modifications to items dealing with governance (covered in Part VI) and with executive and other high-paid employee compensation (covered in Part VII and Schedule J and its instructions). It is not intended as a description of all changes and does not cover Forms 990-N and 990-EZ for small organizations and 990-PF for private foundations.

In addition to being the IRS's primary source for information on tax-exempt organizations and the basis for audits of those organizations, Form 990 often serves similar purposes for state governments. The form also must be made available to the public and can be a key source of information for the press, bloggers, donors and others. In light of these various uses of Form 990, the process for completion should ensure both accuracy and, when narrative explanations are required or permitted, an effective portrayal of the organization's structure and activities. One of the Form 990 questions asks for a description of the organization's process for reviewing the form; this and other considerations have prompted some organizations to consider a prefiling review by the board of directors (or at least by key committees) a best practice Review by board members is another factor impelling a need for accuracy and effectiveness of disclosure.

The governance- and compensation-related items often are among the form's most scrutinized parts. Although some think the questions in these areas go too far, the IRS says it has the right to ask them and that they further tax law compliance.

Notable changes to Part VI

Some significant changes to Part VI, which addresses governance, follow:

Schedule O explanation is required when board delegates to executive committee. Part VI, Section A, Line 1a and related instructions require the organization to include on Schedule O – the supplemental information schedule – details about its executive or similar committee's composition and scope of authority in certain situations. The information must be provided when the governing body (typically, a board of directors or trustees) or its documents (typically, the bylaws) delegate authority to the committee to act on its behalf, the committee has "broad authority" to act on the governing body's behalf, and the committee holds such authority at any time during the tax year for which Form 990 is filed. This requirement does not apply to authority that is "limited in scope to particular areas or matters," such as responsibility delegated to an audit, investment or compensation committee. The 2010 form included a similar requirement in the instructions only – nothing about the requirements was included on the form itself – with slightly less detail.

Officer and employee roles may compromise director independence. Part VI, Section A, Line 1b requires the organization to list the number of governing body voting members who are "independent." The 2011 form instructions (like those for 2010) include four criteria for "independence" but add new, interrelated examples to show how individuals may fail to meet one of those criteria – not being compensated for serving as an officer or an employee. The examples illustrate how a school board chair would not be considered an independent member of the school's governing body if he or she performed officer/employee responsibilities, such as conducting staff meetings and engaging in teacher and staff evaluations, and was compensated for doing so.

Some business relationships may not compromise director independence. If a member of the board of directors – or his or her "family member[s]" – engaged in a transaction that must be reported on Schedule L, "Transactions with Interested Persons" (discussed in more detail below), the board member is not considered "independent." The 2011 instructions include a new example involving a law firm to illustrate when a transaction will and will not give rise to Schedule L disclosures. In the example, transactions with the law firm compromise the independence of a partner with profit and capital interests greater than 5% but not an associate with no ownership or officer, director or trustee role in the firm.

Committee policies suffice as organization policies. Questions in Section B of Part VI ask whether the organization maintains certain policies (for example, whistleblower or document retention and destruction policies). The 2011 instructions clarify that the answer to these questions can be "yes" if either a committee or the governing body adopted the policy.

Making Form 990 available to board on request is not "providing" the form. As was the case for the 2010 form, the 2011 form asks in Line 11a whether a complete copy of Form 990 (deemed to also include required schedules) was provided to members of the governing body before filing. The 2011 instructions clarify that giving board members a link to the form on a website will constitute "providing" the form, but merely telling board members that the form is available on request will not.

Notable changes to Part VII and Schedule J

Some important 2011 changes to Part VII and Schedule J, which address director, executive and similar individuals' compensation, follow:

"Greater of" formula added to definition of "reportable compensation." Part VII, Schedule A of the form and Schedule J, Part II require the organization to report compensation and other information for "officers, directors, trustees, key employees, and highest compensated employees." These positions are defined in the form and instructions. Compensation is broken down in different ways in Part VII and in Schedule J but, in general, a threshold division is "reportable" compensation and "other" compensation. In recent years, "reportable compensation" for employment was defined as Form W-2, Box 5 compensation: Medicare wages and tips. For the 2011 form, however, the definition of "reportable compensation" is the greater of Box 5 compensation or Form W-2, Box 1 compensation: "wages, tips and other compensation" taken into account for income tax purposes. The differences between Box 1 and Box 5 wages will vary by employer and should be reviewed by an organization's tax adviser, but the following examples illustrate some distinctions:

- Elective deferrals to 401(k) and 457(b) plans are not included in Box 1 for the year in which they are made but are included in Box 5 for that year (assuming the elective deferrals to any 457(b) plan are not subject to a substantial risk of forfeiture when made).

- If an employee is covered by a 457(f) nonqualified defined contribution plan, amounts no longer subject to a substantial risk of forfeiture would generally be included in both Box 1 and Box 5 wages (although the definition of "substantial risk of forfeiture" – under Sections 457(f) and 3121(v)(2) of the Code and regulations – may differ for each wage category). The amounts treated as both Box 1 and Box 5 wages generally would include plan earnings to the date the substantial risk of forfeiture lapses. Earnings after that date would be treated as Box 1 wages when actually or, if earlier, constructively received but would generally not be treated as Box 5 wages.

"Other compensation" excludes amounts deferred for no more than 2 1/2 months. In general, deferred compensation that is not "reportable" compensation is reported in the "other" compensation column in Part VII, Schedule A of the form and in the "retirement and other deferred compensation" column in Schedule J, Part II. For the 2011 form, the instructions indicate that amounts deferred from the tax year for which the form is being filed to a date not more than 2 1/2 months after the end of the tax year are not treated as deferred compensation for these purposes.

Presumably, these amounts will now be treated as "reportable" compensation. Note that, for income tax purposes and, thus, treatment as "wages" in Form W-2, Box 1, these amounts typically would be included when actually or constructively received. For Medicare tax purposes and, thus, treatment as "wages" in Form W-2, Box 5, the Section 3121(v)(2) regulations ordinarily allow the employer a choice of treating these amounts as "deferred compensation" (and, thus, Medicare wages when there is no longer a substantial risk of forfeiture) or as nondeferred compensation (and, thus, Medicare wages when paid).

Actuarial decreases in defined benefit plans considered for computing "other" compensation but disregarded for Schedule J threshold reporting test. The instructions for the 2011 form clarify that, when completing the "other" compensation column in Part VII, Schedule A, annual actuarial decreases – as well as increases – in qualified and nonqualified defined benefit plans should be taken into account. They further state, however, that actuarial decreases in defined benefit plans are disregarded for purposes of the Part VII, Schedule A, Line 4 question that asks whether the sum of an individual's "reportable" and "other" compensation is greater than $150,000 – a threshold test for whether certain individuals' compensation must also be reported on Schedule J.

Explanation of compensation-setting actions by related organizations required. As has been the case in prior years, Part I, Question 3 of Schedule J asks whether the filing organization used one or more of six specified ways to determine compensation for the CEO/executive director – for example, an employment contract or a compensation survey or study. The 2011 form states that, if one or more of the specified ways was used by an organization related to the filing organization, rather than the filing organization itself, the filing organization should not check boxes to show what the related organization did but should explain the related organization's actions in the Schedule J, Part III portion of the form provided for narrative explanations.

Description of severance, change-in-control and nonqualified retirement plans required. As in prior years, Part I, Line 4 of Schedule J asks whether individuals reported in Part VII, Schedule A received a severance payment or change-in-control payment and whether they participated in or received payment from a nonqualified retirement plan. For 2011, an organization must provide a description in Schedule J, Part III of the "terms and conditions" of any such arrangement. In prior years, amounts provided under the arrangements had to be included in Part III, but nothing expressly required a description of their "terms and conditions."

Other parts of the form

Schedule L, "Transactions with Interested Persons," is an important compensation-related part of Form 990. Among other things, it is used to provide information on "excess benefit transactions," to which the intermediate sanctions rules of Section 4958 apply, and to provide information on loans to officers, directors, trustees and key employees. As with all other portions of the form, an organization should carefully review the various line items and instructions, but it appears that the 2011 Schedule L is substantially similar to the 2010 Schedule L.

Tax-exempt hospital organizations will need to invest time in preparing Schedule H, "Hospitals." It includes several revised items, and new 2011 requirements make completion of substantially all portions of Schedule H mandatory. **Full text of Form 990 (IRS, 20 Jan 2012)**; **Full text of Form 990 instructions (IRS, 17 Jan 2012)**; **Full text of Schedule H (IRS, 20 Jan 2012)**; **Full text of Schedule H instructions (IRS, 17 Jan 2012)**; **Full text of Schedule J (IRS, 20 Jan 2012)**; **Full text of Schedule J instructions (IRS, 17 Jan 2012)**; **Full text of Schedule L (IRS, 18 Jan 2012)**; **Full text of Schedule L instructions (IRS, 17 Jan 2012)**; **Full text of Schedule O (IRS, 20 Jan 2012)**

Employee who exhausts leave has no claims under the ADA or FMLA: An employee with cancer fired after using all his Family and Medical Leave Act (FMLA) leave cannot pursue claims under that law or the Americans with Disabilities Act (ADA), the 10th US Circuit Court of Appeals has ruled. The court found neither law applied because the employee had exhausted his 12-week annual leave entitlement under the FMLA and could not perform his job's essential functions even with a reasonable accommodation, as required by the ADA. The ruling suggests best practices, while clarifying employers' federal-law obligations to employees on medical leaves of absence. *The case is Valdez v. McGill and Mueller Supply Co., Inc. (10th Circuit, Feb. 13, 2012);* Full text of ADA enforcement guidance on reasonable accommodation and undue hardship (EEOC, 17 Oct 2002)

ADA does not entitle disabled employee to priority for vacant job: The ADA does not require an employer to prefer a disabled employee seeking reassignment to a vacant job over a more qualified nondisabled individual, the 7th US Circuit Court of Appeals has ruled. The decision perpetuates a split among circuit courts over the extent of an employer's obligation to reassign workers with disabilities. Nearly all the courts recognize that reassignment is a form of accommodation under the ADA when disabled employees cannot perform their jobs, even with accommodations. But courts differ over how far employers must go to accommodate employees through reassignment. *The case is EEOC v. United Airlines, Inc. (7th Circuit, March 7, 2012)*

Counties where health plans must provide foreign-language notices updated for 2012: An updated list identifies counties where certain group health plans must include foreign-language statements in claim or appeal denial notices and summaries of benefit and coverage (SBCs). For 2012, 246 US counties have 10% or more of their residents literate in the same non-English language ***(Spanish, Tagalog, Chinese or Navajo)***. Any claim/appeal denial notice or SBC sent to those counties' residents must have a non-English statement offering translation help. Rather than track which counties trigger which language, employers may decide to use all four non-English statements in all notices. Full list of counties needing non-English notices (CCIIO, 9 Mar 2012); Full text of model claim denial notice with non-English statements (DOL, 22 Jun 2011)

States are not liable under FMLA's self-care rules, Supreme Court says: Sovereign immunity protects state employers -- including schools, hospitals, courts and other state instrumentalities -- from liability under the Family and Medical Leave Act's "self-care provision," which entitles employees to take leave for their own serious health conditions, the US Supreme Court has ruled. But the ruling does not entirely eliminate states' exposure. Employees can still try to convince DOL to sue on their behalf; sue states under analogous state family and medical leave laws; sue their bosses, seeking recovery from the boss's personal assets; and sue for nonmonetary relief. *The case is Coleman v. Court of Appeals of Maryland (US Supreme Court, March 20, 2012)*

Final rules explain how health care reform affects student health insurance: Colleges and universities must act quickly to ensure that student health insurance plans comply with many health care reform provisions for policy years starting on or after July 1, 2012, under recently issued final regulations. Special transition rules allow student health plans to have lower annual dollar limits on essential health benefits than other reform-covered plans. A special exception will allow certain religiously affiliated institutions to delay and potentially avoid covering contraceptives under their student health plans. Full text of final HHS regulations (Fed. Reg., 21 Mar 2012); Full text of fact sheet (HHS, 16 Mar 2012)

Attendance policy may violate ADA's ban on disability inquiries, court finds: An employer may have violated the Americans with Disabilities Act (ADA) by requiring doctors' notes disclosing the reasons for employees' health-related absences, a federal district court has ruled ***(EEOC v. Dillard's, Inc., US District Court, Southern District of California, Feb 19, 2012)***. Though the employer argued its attendance policy sought only a general diagnosis and not any details that would reveal a disability, the court disagreed. Instead, the court held that a jury should decide whether the policy violated the ADA or served essential business or safety needs. The ruling underscores the ADA challenges employers face in managing absenteeism and leave abuse. Full text of EEOC enforcement guidance on disability-related inquiries and medical exams of employees under ADA (27 Jul 2000)

State employers cannot be sued under GINA, court says: Sovereign immunity shields state employers from liability under the Genetic Information Nondiscrimination Act (GINA), a federal district court has held. The ruling is the first to address whether state employers -- including hospitals, schools and other instrumentalities -- can face damage claims under GINA. Though Congress clearly meant for GINA to protect state employees, the court found no unconstitutional pattern of genetic bias by states. The decision mirrors the recent Supreme Court ruling on states' liability under the "self-care provision" of the Family and Medical Leave Act. *The case is Culbreth v. Wash. Metro. Transit Authority (D. Md. March 19, 2012).*

IRS's surprising position on 415 limits could mean lower pension benefits: A new IRS interpretation of Code Section 415 limits could sharply reduce pension benefits for some participants whose distributions begin before normal retirement age or are paid as a qualified joint and survivor annuity. So far, agency officials have expressed only informal, individual views, but authoritative guidance confirming the new interpretation may be published soon. If so, the guidance would represent a fundamental break with the long-standing, widely held understanding of how the Section 415 limits work.

Conventional wisdom: Two subsidies available under 415

Code Section 415 imposes a maximum dollar limit ($200,000 in 2012) on benefits payable each year to a retiree under a defined benefit plan. The limit applies to the amount payable as a single-life annuity at age 65; adjustments are generally required when benefits begin at a different age or are paid in a different form. But the pension community has long understood that the adjustment rules allow two valuable subsidies: (i) The limit is unreduced for early retirement at age 62 or later, and (ii) no form-of-payment adjustment is necessary when an employee elects a qualified joint and survivor annuity (QJSA).

Example. A pension plan defines the accrued benefit as a single-life annuity starting at age 65. When a participant retires early, the benefit is reduced 3% for each year commencement precedes age 65. If the benefit is paid as a 100% QJSA, an optional form factor of 88% applies. Donald retires at age 62 and elects the 100% QJSA. His plan formula benefit – before applying the 415 limit – is a single-life annuity of $250,000 per year starting at age 65. After applying the early retirement and optional form reductions, his formula benefit is $200,200 per year, determined as $250,000 × [100% - (3% × 3)] × 88%. Because this exceeds the 415 limit of $200,000 per year, conventional wisdom has been that the plan could pay Donald $200,000 per year in the 100% QJSA form.

New IRS stance at odds with conventional wisdom

Regulations published in 2007 clarified that Section 415 restricts accruals, not merely payments (for plans other than governmental or church plans). According to informal comments from IRS officials, this means that the accrued benefit (typically, the single-life annuity at age 65) is limited to $200,000 before applying the plan's early retirement and QJSA reduction factors.

Example. Same facts as above, but the IRS interpretation is applied to the calculation. Donald's benefit at age 62 would be $160,160 per year, determined as $200,000 × [100% - (3% × 3)] × 88%, or 20% less than under the conventional interpretation. To pay Donald $200,000 per year, the plan would have to provide unreduced benefits at age 62 (or use normal retirement age 62) and fully subsidize the QJSA.

IRS officials have expressed this view in various public forums, including the Conference of Consulting Actuaries meeting in October 2011 and the Enrolled Actuaries Meeting in March 2012.

While certain plan design modifications might get around the resulting benefit reduction, any attempt to add subsidies for participants affected by 415 limits – but not for other participants – may run afoul of nondiscrimination rules.

Actuaries express concern with IRS interpretation

The American Academy of Actuaries has submitted a comment letter expressing significant concern and explaining why the new interpretation is contrary to both the statute and the 2007 regulations. But IRS representatives seem to be standing firm and have indicated that formal guidance supporting this position is forthcoming. It isn't clear when that guidance will be released, how it might affect benefits already in pay status under a qualified plan and any related nonqualified excess plan, or whether a qualified plan's determination letter would offer any protection for past practices.