VEDDER PRICE

# Employee Benefits Briefing

A bulletin designed to keep clients and other friends informed on employee benefits law matters

July 2005

## IRS PERMITS GRACE PERIOD FOR FSA CLAIMS

On May 18, 2005, the IRS issued Notice 2005-42 permitting cafeteria plans to add a 2½- month grace period to the "use-it-or-lose-it" rule that applies to Flexible Spending Accounts ("FSAs").

### *What Is the Change?*

Under Notice 2005-42, a participant may incur eligible expenses up to 2½ months after the end of the plan year and still present those receipts for reimbursement from the prior year's FSA. The effect of this change (for calendar year plans) is that expenses incurred between January 1st and March 15th could be applied first against any existing balance in last year's FSA and then to the current year's FSA.

*Example*: An employee elects to contribute $1,000 to a health care FSA during 2005 and has $200 remaining as of December 31, 2005. The employee also elects to contribute $1,500 to a health care FSA during 2006. The employee incurs a $300 charge in January 2006. The plan can apply $200 of that charge against amounts remaining in the 2005 FSA, and then apply $100 of the charge against the 2006 FSA. Thus, after applying that charge, the employee would have $0 in the 2005 FSA and $1,400 in the 2006 FSA.

This change is optional, effective immediately, and can be implemented for the current 2005 plan year if the plan sponsor amends its cafeteria plan before the end of the 2005 plan year.

Notice 2005-42 does not change other rules that apply to FSAs. For example, it does not change the "use-it-or-lose-it" rule (it only adds a grace period). Thus, if there are unused amounts in the FSA after the end of the grace period, they must be forfeited.

Similarly, participants cannot use expenses incurred for one type of FSA for reimbursement under another type of FSA. Thus, a participant who has used all of his/her health care FSA cannot present a medical expense (whether incurred during the year or during the grace period) for reimbursement from his/her dependent care FSA.

### *Implementing the Change*

If you wish to implement this change for the current plan year, you will need to amend your cafeteria plan before the end of the plan year (*i.e.*, by December 31, 2005 for calendar year plans). You will also need to communicate this change to participants so they know the deadline for incurring expenses.

As with any change like this, the devil will be in the details, and it will be necessary to coordinate this change with your benefits staff and/or your third party administrator. For example, cafeteria plans often have a so-called "run-out" period of around 3 months after the end of the plan year during which participants may

IN THIS ISSUE

IRS PERMITS GRACE PERIOD FOR FSA CLAIMS — Page 1
KNOW YOUR CURRENT PLAN FEES — Page 2
IMPACT OF NEW BANKRUPTCY ACT ON EMPLOYEE BENEFIT PLANS — Page 3

present receipts incurred during that year. Thus, a participant who incurs a reimbursable expense on December 20th may often be able to present that receipt for reimbursement up to March 31st of the following year. Presumably as part of implementing this change, the "run-out" period for many plans will need to be extended (*e.g.*, to June 30th) to permit participants to present receipts incurred during the grace period.

In addition, it will be necessary to address such things as the ordering of claims processing as it relates to the grace period. For example, if a participant presents a receipt for an expense incurred during the grace period before presenting a receipt for an expense incurred in the prior year, how will the reimbursement be structured? If the first claim is automatically applied to the prior year's FSA, the second claim may be useless. One possible solution to this issue would be to require the participant to designate which year the grace period receipts apply. Another possible solution would be to specify and communicate to participants how the ordering procedure will apply. Unfortunately, Notice 2005-42 does not address some of these implementation issues.

Although this change is primarily directed at health care spending accounts, it would also appear to apply to dependent care spending accounts. However, the carryover of unused amounts in such an account will create complications in applying the annual $5,000 limit under Internal Revenue Code Section 129. Additional guidance may be required on this issue, including whether the plan amendment can limit the grace period to medical care spending accounts.

Employers considering the adoption of a Health Savings Account in 2006 may not want to adopt the grace period this year in order to avoid inadvertently disqualifying employees from eligibility (since the spending account is not a high deductible health plan). Further guidance on this issue from the IRS would be helpful. In addition, clarification on the application of HIPAA and COBRA to health care spending accounts that are amended to provide for a grace period may also be necessary.

If you have any questions about this issue and how it may apply to your plan, or would like assistance in amending your plan, please contact Phil Mowery, or any benefits attorney with whom you work.

## KNOW YOUR CURRENT PLAN FEES

Two recent developments highlight and re-emphasize the duties of plan fiduciaries to maintain their vigilance in understanding and evaluating all fees paid by a plan.

In the first development, the Securities and Exchange Commission has issued a staff report on pension consultants. The report discusses potential conflicts of interest in the area of pension consulting. Pension consultants need to establish their independence to act on behalf of the plans they represent. Yet actual circumstances may question that independence in several ways, and plan fiduciaries may need to determine their independence.

For example, many pension consultants provide services to both plans and money managers. Often the money managers may pay to the consultants fees for conferences or courses conducted by the consultants. The study raises the question of whether such fees are paid in order to increase the likelihood of their selection as plan advisors. In other situations, plan consultants may benefit from plan brokerage fees whether those fees are paid to affiliated or unaffiliated brokers. The study questions whether such arrangements result in an increased chance that an active trading strategy will be recommended.

The study does not provide any answers to the questions it raises. But it highlights for plan fiduciaries the need to review existing practices and perhaps ask further questions when consultants are selected or reviewed.

In the second development, the Department of Labor has restated its long-standing position about similar potential conflicts of interest involving mutual funds. The Department of Labor has long held that plan fiduciaries may not receive additional fees from mutual funds. In the recent opinion, the Department considered

an arrangement where a bank fiduciary offering asset allocation services for a set fee also received additional fees from the mutual funds (so-called 12b-1 fees) offered in the program. The Department said the fees received by a fiduciary from the mutual fund were permissible as long as the bank offset such fees against the bank's standard fee.

These developments provide a timely reminder to plan fiduciaries to be proactive in this area. Uncovering potential conflicts of interest and unearthing all direct and indirect fee arrangements requires attentiveness and diligence. It is clear that all government agencies have this issue at the top of their examination list. Plan fiduciaries need to do the same by asking consultants and trustees about their arrangements with money managers and mutual funds.

If you have any questions about this issue, please contact John Jacobsen, or any benefits attorney with whom you work.

## IMPACT OF NEW BANKRUPTCY ACT ON EMPLOYEE BENEFIT PLANS

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act"), signed by President Bush on April 26, 2005, includes a number of provisions relating to employee benefit plans. This article summarizes the major changes. Except as otherwise noted, these changes are effective for bankruptcy filings on or after October 17, 2005.

***Benefits Excludable from Bankruptcy Estate***

The Act now allows a debtor to exclude from the bankruptcy estate any benefits that are exempt under the following Internal Revenue Code sections: 401(a)a (tax-qualified plans); 403 (tax-sheltered annuities); 408 (individual retirement accounts and annuities); 408A (Roth IRAs); 414 (governmental and church plans); and 457 (not-for-profit and state and local government plans). This expands upon the earlier U.S. Supreme Court decision in *Patterson v. Shumate* that generally allowed qualified plan benefits to be excluded and the more recent decision in *Rousey v. Jacoway* that allowed IRA accounts to be excluded. To be excluded from the bankruptcy estate, the plan must either have a favorable IRS determination letter or demonstrate substantial compliance with applicable Code requirements. Under the Act, the exclusion for IRAs is limited to $1,000,000 determined without regard to rollovers from qualified plans.

***Plan Loans***

Participants' filing for bankruptcy with an outstanding plan loan has long been a problem for plan administrators. Under the Act, loan repayments are no longer subject to an automatic stay and the loan is not dischargeable in the bankruptcy proceeding. As a result, loan deductions may be continued without seeking a reaffirmation of the loan from the bankruptcy court.

***Protection of Plan Contributions from Employer's Bankruptcy***

The Act also provides that amounts withheld from an employee's wages or other amounts received by an employer for payment of contributions to any ERISA plan, governmental plan or tax-sheltered annuity are excluded from the employer's bankruptcy estate. This will protect employees' plan contributions that were withheld from pay but not deposited in the plan's trust before the bankruptcy filing by the employer.

***Retiree Health Benefits***

The Act also provides that retiree health benefits that were modified 180 days before an employer's bankruptcy petition must be reinstated if the employer was insolvent at the time of the modification. An exception exists if the court finds that a "balance of equities" test favoring the modification is satisfied by the employer. This section was enacted to prevent evasion of the Bankruptcy Code's provision against modifying retiree benefits by modifying them

immediately before filing for bankruptcy. This provision applies to cases filed on or after April 20, 2005.

***Obligation to Administer Plan***

The Act requires plan administrators to continue to administer an employee benefit plan after the employer's bankruptcy filing unless the bankruptcy trustee assumes these obligations. This provision is intended to limit the number of "orphan" plans as a result of an employer's bankruptcy.

If you have any questions about this issue, please contact Paul Russell, or any benefits attorney with whom you work.

Contributing Authors: Paul F. Russell, John J. Jacobsen, Jr. and Philip L. Mowery.

If you have any questions regarding material in this issue of *Employee Benefits Briefing,* contact Paul F. Russell *(practice leader)* at 312/609-7740 or at prussell@vedderprice.com or any member of the Employee Benefits Group.

*Employee Benefits Briefing* is published by the law firm of Vedder, Price, Kaufman & Kammholz, P.C. It is intended to keep our clients and interested parties generally informed of legal developments in employee benefits. It is not a substitute for professional advice.

© 2005 Vedder, Price, Kaufman & Kammholz, P.C. Reproduction is permissible with credit to Vedder, Price, Kaufman & Kammholz, P.C.

## VEDDER, PRICE, KAUFMAN & KAMMHOLZ, P.C.

### About Vedder Price

Vedder, Price, Kaufman & Kammholz, P.C. is a national, full-service law firm with more than 210 attorneys in Chicago, New York City and New Jersey.

*Chicago*
222 North LaSalle Street
Chicago, Illinois 60601
312/609-7500
Fax: 312/609-5005

*New York*
805 Third Avenue
New York, New York 10022
212/407-7700
Fax: 212/407-7799

*New Jersey*
Five Becker Farm Road
Roseland, New Jersey 07068
973/597-1100
Fax: 973/597-9607

www.vedderprice.com

### The Employee Benefits Group

Vedder Price has one of the nation's largest employee benefits practices, with ongoing responsibility for the design, administration and legal compliance of pension, profit sharing and welfare benefit plans with aggregate assets of several billion dollars. Our employee benefits lawyers also have been involved in major litigation on behalf of benefit plans and their sponsors. Our clients include large national corporations, smaller professional and business corporations, multiemployer trust funds, investment managers and other plan fiduciaries.

*Employee Benefits Group:*

Mark I. Bogart .......... 312/609-7878
Michael G. Cleveland .......... 312/609-7860
Christopher T. Collins .......... 312/609-7706
Thomas P. Desmond .......... 312/609-7647
John H. Eickemeyer .......... 212/407-7760
Thomas G. Hancuch .......... 312/609-7824
John J. Jacobsen, Jr. .......... 312/609-7680
Neal I. Korval .......... 212/407-7780
Alison J. Maki .......... 312/609-7720
Philip L. Mowery .......... 312/609-7642
Stewart Reifler .......... 212/407-7742
Paul F. Russell *(Practice Leader)* .......... 312/609-7740
Robert F. Simon .......... 312/609-7550
Kelly A. Starr .......... 312/609-7768
Lawrence L. Summers .......... 312/609-7750
Charles B. Wolf .......... 312/609-7888