Benefit$Alert

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Hardship Distributions Are Increasing 401(k) Plan Errors

Employees who can no longer tap into the equity in their homes are beginning to draw upon their 401(k) plans for hardship distributions. Plans must follow strict tax rules when making these distributions. Not surprisingly, IRS auditors are seeing an increase in problems related to them. It's time to brush up on these rules.

HARDSHIP DISTRIBUTION ABCS

Plans don't have to allow hardship distributions, and they're not a snap to execute. Plans must state whether employees can take hardship distributions and under what circumstances. Typically, distributions allow employees to pay for unforeseeable emergencies. *Examples:* medical expenses, funeral expenses, home repair expenses, expenses necessary to prevent eviction or foreclosure, tuition expenses, and expenses related to the purchase of a home. *Tip:* Plans can limit the circumstances under which distributions may be made. For example, plans may allow distributions to pay for funeral or medical expenses, but not to purchase a home.

You can't make hardship distributions to employees if you have actual knowledge that they can arrange alternative financing, such as liquidating other assets, stopping contributions into the plan, or borrowing from other commercial lenders. Hardship distributions may be made only under these circumstances.

- Distributions must be necessary to satisfy employees' immediate and heavy financial needs.
- Employees must have obtained all other currently available distributions from loans under the plan.
- Employees are prohibited from making pre-tax contributions and after-tax contributions for at least six months after receiving their distributions.

AVOIDING MISTAKES

Knowledge is power. Employers with a better understanding of the circumstances under which hardship distributions may be made will make fewer mistakes. Here are a few things you can do to cut down on mistakes.

- Review the language in

Robert S. Golden
M. Dennis Guappone
Stephen H. Peck

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181 Wells Avenue
Newton, MA 02459
Phone: (617) 969-0100
www.ubserv.com

Just Charge That To My 401(k) Account

Not all 401(k) plans allow participants to take out loans. But for those that do, the latest tool is 401(k)-plan-linked debit cards. The debit cards are easier to use, as employees don't have to pester Benefits for the loan papers or Payroll to withhold the amounts they're paying back. But they are controversial, for those very reasons. Before your 401(k) plan agrees to hand out debit cards, there are some details potential borrowers might like to know.

READ THE FINE PRINT

Not all debit cards are alike. The card you swipe at the supermarket automatically deducts money from a checking or savings account. 401(k) debit cards are loans, which must be paid back, or else the borrowers will incur tax penalties. In addition, borrowers must pay interest and will likely incur fees. While some of the interest paid will go back into their 401(k) accounts, a certain amount (called the margin) is paid to the card vendor. Other fees may apply, as well:

- annual fees;
- set-up fees;
- cash-advance fees; and
- fees for other services, such as express delivery.

In addition, money set aside for borrowing is parked in a money market fund, until withdrawn. Money market funds may earn lower interest rates than other 401(k) investment options.

BORROWER BEWARE

Under IRS rules, loans must be limited to $50,000 or 50% of borrowers' account balances; loans must be paid back in equal installments over five years; and interest must be charged. Borrowers don't have a lot of leeway — under the tax code, if they miss three consecutive months of payments, their loans will be considered deemed distributions. Borrowers will then have to pay taxes on their loan balances, and if they're younger than 59½, a 10% penalty.

Finally, borrowers usually pay back their loans through paycheck withholding. That isn't the case with debit cards. Borrowers must pay the balance themselves, which can be challenging, especially during these times. ❖

Hardship Distributions Are Increasing 401(k) Plan Errors (cont.)

your plan to determine when and under what circumstances hardship distributions can be made. Communicate these circumstances clearly to all employees.

- All plan documents must be amended from time to time. When your plan is amended, ensure that provisions regarding hardship distributions are contained in the most recent documents.
- Establish effective hardship distribution procedures. Generally, procedures must require employees to describe their hardship and verify they have no other resources, including potential loans from the plan, to meet their current financial crisis. Work with your third-party administrator to determine if your procedures are sufficient to avoid mistakes.

AVOIDING ABUSE

401(k) plans aren't bank accounts; they're retirement accounts. Even so, employees may feel comforted to know that there's a pot of money they can tap when things get really, really bad. To keep employees from treating their 401(k) accounts like ATM machines, you should look for signs that the program is being abused or badly managed.

- Too many hardship requests by employees in the same department or the same location may be a sign of abuse.
- Multiple employees use identical language in their requests for hardship distributions. Each employee's financial situation is unique, so their hardship distribution should be unique, too.
- Hardship distributions must be open to everyone. If only highly compensated employees are taking hardship distributions, this may be a clue that rank-and-file employees haven't been properly notified of the availability of hardship distributions. ❖

Federal Laws Impact Group Health Plans

Group health plans must get ready for some new mandates, thanks to two new federal laws — the American Recovery and Reinvestment Act of 2009 (otherwise known as the economic stimulus law) and the Children's Health Insurance Program (CHIP) Reauthorization Act of 2009. Here's the rundown.

COBRA COMPLICATIONS ARISE FROM ECONOMIC STIMULUS LAW

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009. A centerpiece of this law is a 65% COBRA subsidy for employees who are involuntarily terminated between September 1, 2008, and December 31, 2009, and who are otherwise eligible to elect COBRA. *Warning:* The law doesn't define involuntary termination. As under regular COBRA law, qualified beneficiaries have an independent right to elect COBRA, and the subsidy will apply to them, as well.

Subsidy details. To ensure that the subsidy is targeted to workers who are most in need, employees must attest that their same-year modified adjusted gross income won't exceed $125,000 ($250,000 for families). The subsidy is completely phased out for taxpayers whose modified adjusted gross income exceeds $145,000 ($290,000 for families). Employees can make a one-time permanent election out of the subsidy.

The federal government is generally not directly picking up 65% of the tab, however. Instead, *COBRA-payable entities* (note that this may or may not be the terminating employer) take a credit in the form of reduced payroll tax deposits. Therefore, it's imperative that you work with your Payroll department or payroll service bureau to ensure that the following information flows between the terminating employer and the COBRA-payable entity:

- the names and addresses of employees who are involuntarily terminated;
- the names and addresses of employees and their qualified beneficiaries who elect the subsidy;
- the dates employees were involuntarily terminated;
- the total monthly subsidy for qualified employees and dependents;
- the dates employees make their subsidized COBRA payments; and
- the dates employees' subsidies end.

Employers that pick up COBRA payments for employees who were *voluntarily* separated (a common experience that occurs during termination negotiations) will have to separate those individuals from COBRA-subsidy-eligible employees, since they're not eligible for the subsidy.

The subsidy is extended to employees with comparable COBRA coverage under state laws. This primarily impacts employers too small for COBRA coverage. *What's comparable:* To be comparable, the right to continuation coverage generally must be to continue substantially similar coverage as was provided under the group health plan at a monthly cost that's based on a specified percentage of the group health plan's cost.

Subsidy periods. The standard 18-month COBRA coverage period doesn't change. The subsidy begins with coverage periods beginning on or after February 17, 2009. So, for most employees, the subsidy began with COBRA checks they wrote in March. Employees' eligibility for subsidized premiums ends with the first month beginning with the earlier of these events.

- The date that's nine months after the first month for which the subsidy applies. Employees are still entitled to the remainder of the regular COBRA coverage period, provided they once again pick up 102% of the cost.
- The end of the maximum COBRA period.
- The date employees become eligible for Medicare or become eligible to be covered under another group health plan. However, eligibility for coverage under another group health plan won't terminate subsidized COBRA coverage if the new plan is limited to dental or vision benefits, to counseling or referral services, or is a flexible spending account or a health reimbursement arrangement.

Employers may allow employees who are eligible for subsidies to elect any health plan options that are offered to current employees, which have the same or lower premiums than their

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Federal Laws Impact Group Health Plans (cont.)

previous health benefits options.

Employees must notify the COBRA-payable entity of their eligibility for new group health benefits. Those who don't notify the entity may be penalized 110% of the premium. Penalties will not be applied if employees simply stop paying their COBRA premiums.

Special enrollment rights. Again, the length of the COBRA coverage period doesn't change. However, employees who originally elected not to take COBRA, and employees who originally elected COBRA but dropped it because they stopped paying their premiums, have a 60-day special enrollment period during which they may decide to take the subsidized premium. The 60-day period begins on the date they receive notice of their special enrollment rights. *Important:* Coverage isn't retroactive to the beginning of what would have been the original COBRA coverage period.

Overpayment credits. Employees who are eligible for the subsidy, but who pay the normal 102% of their COBRA premiums for any month during the 60-day period beginning in March 2009, may have those overpayments credited toward their future subsidized payments. *Hitch:* The COBRA-payable entity must be reasonably certain that the credit will be used within 180 days of the overpayment. If the COBRA-payable entity isn't reasonably certain, it must reimburse employees for the amount of their overpayments within 60 days.

Notice requirements. Current COBRA notices must be rewritten to include comprehensive information regarding the subsidy. A new notice describing special enrollment rights must also be provided to employees. The Secretary of Labor will release a model notice regarding special enrollment rights shortly.

SPECIAL ENROLLMENT RIGHTS IN CHIP LAW

Beginning April 1, 2009, the Children's Health Insurance Program (CHIP) Reauthorization Act of 2009, which provides health insurance to uninsured children, requires group health plan administrators to provide information to the state, upon request, regarding the group health benefits available to employees or dependents who are covered under Medicaid or a CHIP plan, or else face a $100-a-day penalty.

The law also requires that group health plans allow employees who are eligible for coverage, but are not enrolled, to enroll if either of the following conditions are met:

- employees or dependents covered under Medicaid or a CHIP plan lose eligibility, and they request coverage under the group plan within 60 days after Medicaid or CHIP benefits are terminated; or
- employees or dependents become eligible for Medicaid or CHIP assistance, if they request coverage within 60 days after the eligibility determination date.

Employers must also provide employees with a written notice of the availability of health premium assistance under Medicaid or a CHIP plan. Employers that fail to honor their notice requirements can be fined up to $100 a day. The law directs the Secretary of Labor to develop a model coverage disclosure form by February 4, 2010. Employers must provide these model notices to employees beginning with the first plan year that begins after the date on which the model notices are issued. ❖