



ERISA Litigation

A report to clients and friends of the firm

Edited by **Stacey C.S. Cerrone** and **Russell L. Hirschhorn**

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Editor's Overview

This month's newsletter focuses on repayment of pension plan overpayments. Our issue discusses pension plan overpayments to participants, a plan administrator's duties to seek repayment, corrections for those overpayments, and the tax implications for such recoupments.

As always, be sure to review the section on Rulings, Filings, and Settlements of Interest including, more post-Winter tax guidance, a discussion of two Circuit Court decisions on whether or not subsidies to buy insurance on an exchange are available in both state and federal exchanges, and a Fourth Circuit decision on equitable remedies.

Righting a Wrong: The "Claim of Right" Doctrine and Other Tax Considerations for the Repayment of Pension Plan Overpayments*

By Justin S. Alex

Pension plan overpayments to participants and their beneficiaries are an all-too-common occurrence. When overpayments occur, a plan administrator's duties are fairly clear. Typically, the plan administrator must seek repayment of the overpayment, plus interest, from the affected individuals, and if recovery from the individuals cannot be completed, recovery must be sought from the employer or other party who caused the overpayments. This article briefly reviews the general options for the correction of overpayments and focuses on the tax implications of overpayment recoupments and repayments by the individuals who received the overpayments.

* Originally published in Bloomberg, BNA. Reprinted with permission.

General Repayment Options

Before discussing the tax consequences of repayments, it is helpful to consider how repayment options generally work. Available repayment options for affected individuals include a one-time lump sum payment, structured repayments over a certain period of time, a reduction in future pension payments through an actuarial adjustment (*i.e.*, “recoupment”),¹ or some combination of the foregoing options. In addition, if the plan administrator’s reasonable efforts to secure repayment (or some plan for repayment) are unsuccessful and the plan provides for automatic recoupment, the plan administrator may be able to automatically reduce the affected individuals’ benefit payments on a prospective basis to reflect the overpayment. However, automatic recoupment is not possible in situations where the plan owes no further benefits to the affected individual (such as in the case of an overpaid lump sum).

If a plan administrator is unable to secure repayment from the affected individuals, the plan sponsor may need to contribute the overpayment amount, plus interest, to the plan.² Single-employer plan sponsors also sometimes elect to make corrective contributions to the affected plan from the plan sponsor’s general assets in lieu of seeking repayment. However, not all plan sponsors are in a financial position to make corrective contributions. In addition, corrective contributions are generally not a viable option for the boards of trustees that sponsor multiemployer pension plans because the boards typically have no assets. As a result, plan administrators often turn to affected individuals for repayments of overpayments.

Tax Questions from Affected Individuals

Conversations with individuals regarding repayments can become tense, particularly because the affected individuals are often on fixed incomes and the overpayments were not necessarily their fault. However, plan administrators must press forward with repayment requests because of their fiduciary duties to their plans and to ensure that the plans have sufficient assets to satisfy benefits liabilities to all participants.

Typically, affected individuals already paid (or had withheld) federal income taxes from their overpayments. As a result, a common question during conversations about repayments is whether the individuals will receive some form of tax refund for the amounts that they repay to the plan. As a general matter, individuals who received overpayments are liable for repaying the full amount of their overpayment and interest, regardless of whether they can obtain tax refunds or deductions for the repayments. While plan sponsors, fiduciaries and administrators should not provide tax advice to individuals about their particular circumstances, it is useful to know the general tax implications of repayments for affected individuals.

¹ Recoupments of overpayments do not violate the anti-alienation rule. Treas. Reg. § 1.401(a)-13(c)(2)(iii).

² Depending on the facts and circumstances, plan fiduciaries may determine that it is not prudent to seek repayments based on the hardship to the affected individual or the cost of collection efforts for the plan. Dep’t of Labor Op. Ltr. 77-08.

What happens when overpayments are deducted or reduced from future pension payments?

Generally, participants and their beneficiaries are only taxed on amounts *actually* distributed to them from a pension plan.³ Typically, there are two options to reduce the amounts actually distributed to the affected individuals going forward.

The first option is to adjust the affected individual's benefits on a prospective basis in a manner that reduces the actuarial present value of the benefits by the amount of the overpayment, plus interest. Going forward, the individual will only be liable for taxes on the adjusted pension amount that the individual actually receives from the plan.⁴ In other words, the individual is not subject to taxation on the amount of his or her benefit that is recouped for repayment. As a result, this is theoretically a tax-neutral solution for the individual. However, from a practical standpoint, it may not make the individual whole if the individual was in a higher tax bracket at the time of receipt of the overpayment. It is also important to note that the individual is not eligible for any deduction under Code Section 165(a) for the subsequent repayment of the overpayment.⁵

In addition, if an individual elects to repay an overpayment with an actuarial adjustment and dies prior to full repayment of the overpayment, plus interest, the plan sponsor should not be required to make a corrective contribution for the outstanding repayment amount from a plan qualification standpoint. However, fiduciary considerations may still require a full restitution to the plan. Individuals sometimes push back on the amount of actuarial adjustments because they believe they will outlive the actuarial assumptions applicable to them and ultimately have their pension benefits withheld by more than the amount of the overpayment, plus interest.

The second option is to structure repayments over a certain period of time in negotiated monthly increments and to withhold the repayment amounts from the individual's pension benefits. If an individual elects this option and dies prior to full repayment of the overpayment, plus interest, the plan sponsor may need to make a corrective contribution to the plan for the unpaid amount.

What happens when repayments are paid in cash?

Other options for repayments from affected individuals do not entail any reductions from their rightful pension benefits. Instead, they typically entail a lump sum repayment or repayments over a fixed time period in cash. The tax treatment for these repayment options depends on whether they occur in the same year of the overpayment.

³ 26 U.S.C. § 402(a).

⁴ Rev. Rul. 2002-84, 2002-2 C.B. 953.

⁵ *Id.*

If cash repayments are made in the same year as the overpayment, they can generally be treated in the same way as a recoupment.⁶ In other words, the repayment would simply reduce the taxable amount received by the affected individual from the plan in the tax year.

If cash repayments are made after the year in which the overpayment occurred, the repayment may be treated as a loss deduction under Code Section 165(a).⁷ However, if the repayment is less than \$3,000, the deduction must be treated as a miscellaneous itemized deduction. As a result, repayments of less than \$3,000 are subject to the 2% adjusted gross income threshold for miscellaneous itemized deductions under Code Section 67(a).

If the repayment is over \$3,000, the adjusted gross income threshold does not apply. Instead, the deduction is based on the rules for the restoration of a substantial amount held under a “claim of right,” which are set forth in Code Section 1341.

Generally, Code Section 1341 provides a refundable credit for repayment tax deductions in excess of \$3,000 if the taxpayer “appeared” to have an unrestricted right to payment in the year of payment.⁸ In the absence of unusual facts and circumstances, the recipient of a pension overpayment likely “appeared” to have an unrestricted right to the payment in the year of receipt.⁹

If Code Section 1341 applies for the repayment, the tax for the taxable year in which the repayment is made is the lesser of: 1) the tax for the taxable year in which the repayment is made computed with the full amount of the repayment (without regarding to the \$3,000 cap), and 2) the tax for the taxable year in which repayment is made computed without any deduction for the repayment, minus the decrease in tax for the taxable year in which the overpayment was received which would result if the overpayment was excluded from gross income for the prior taxable year. If the application of Code Section 1341 results in a tax decrease that exceeds the tax liability for the taxable year of the deduction, the tax decrease can be used to generate a refund or tax overpayment.¹⁰

⁶ See, e.g., Rev. Rul. 79-311, 1979-2 C.B. 25 (finding that where employee repaid excess commissions in the same year as receipt, the repaid commissions were excludable from the employee’s gross income in the year of repayment).

⁷ Rev. Rul. 2002-84, 2002-2 C.B. 953.

⁸ There are a number of other technical requirements in connection with Code Section 1341 that are beyond the scope of this article.

⁹ The appearance of an unrestricted right is generally the “semblance of an unrestricted right in the year received.” Rev. Rul. 68-153, 1968-1 C.B. 371. As a result, Code Section 1341 may not be available if the plan administrator sought repayment immediately prior to the end of a taxable year and actual repayment was not made until the following taxable year.

¹⁰ 26 U.S.C. § 1341(b)(1).

Proskauer's Perspective

When discussing repayments with individuals who received overpayments of pension benefits, plan sponsors, fiduciaries and administrators should never provide specific tax advice. That said, it is useful to bear in mind that tax deductions are typically available to affected individuals and it may be appropriate to provide general information to affected individuals, with the caveat that they should seek their own tax advice from an accountant or legal counsel. Although the available tax deductions may not truly make affected individuals whole for the taxes they paid on overpayment amounts, knowing that some recourse is available to them can often help cool heated discussions regarding the repayment of overpayments.

Rulings, Filings, and Settlements of Interest

Fourth Circuit Rejects Widow's Claim for Equitable Relief

By Todd Mobley

- > The Fourth Circuit recently rejected fiduciary breach and equitable estoppel claims for life insurance coverage by Leslie Moon, the widow of a deceased employee, who claimed that the employer's actions resulted in Mr. Moon's failure to convert his life insurance to an individual policy following the onset of his disability. In so ruling, the Court determined that Leslie Moon failed to establish that the employer was a fiduciary of the life insurance plan because: (i) the employer's alleged failure to alert Mr. Moon that he was no longer covered under the plan and its continued acceptance of Mr. Moon's premium payments (when such payments should have been made directly to the insurer) constituted administrative, not fiduciary, functions; and (ii) the plan was administered by third party. The case is *Moon v. BWX Techs., Inc.*, No. 13-cv-1888, 2014 U.S. App. LEXIS 12525 (4th Cir. July 2, 2014).

More Post-Windsor Tax Guidance: IRS Issues Letter Outlining Steps for Individuals to Obtain Tax Refunds for Same-Sex Spousal Health Coverage

By William Fogleman, Roberta Chevlowe and Tzvia Feiertag

- > On June 27, 2014, the IRS published a letter outlining the steps taxpayers should take in order to obtain a refund for taxes paid on the value of employer-sponsored health coverage provided to an employee's same-sex spouse. The [letter](#), originally dated February 24, 2014, is in response to an inquiry from Rep. Peter Welch of Vermont, who had requested guidance on the issue on behalf of a constituent.

The IRS addressed a fact pattern in which a taxpayer's employer issued the taxpayer a Form W-2 that reports the value of spousal health coverage as taxable wages. Following the Supreme Court's decision in *United States v. Windsor*, the IRS announced in Rev. Rul. 2013-17 and Notice 2014-1 that a same-sex spouse will be treated as a spouse for federal tax purposes, provided the couple is lawfully married under state law. Therefore, as is the case with opposite-sex spouses, the value of employer-sponsored health coverage provided to an employee's same-sex spouse is excludable from an employee's income for federal tax purposes. The Form W-2 issued to the taxpayer by the employer was therefore inaccurate.

The IRS instructs that the taxpayer should contact her employer and request a corrected Form W-2, which the taxpayer can then use to complete her tax return. If the employer does not issue a corrected Form W-2, the taxpayer should file her tax return using the original Form W-2 and file a Form 4852 (Substitute for Form W-2 or Form 1099-R) reporting the correct amount of her taxable wages (subtracting the value of excludable spousal health coverage). Where Form 4852 asks to describe how the taxpayer determined the corrected amounts, she should explain that the amounts reported on Form W-2 included the value of excludable spousal health coverage and that these amounts have been excluded on Form 4852 as permitted by Rev. Rul. 2013-17 and Notice 2014-1. The taxpayer should also explain how she determined the value of the excludable spousal health coverage. The taxpayer should then complete her tax return using the amounts in Form 4852 instead of the incorrect Form W-2.

The IRS also notes that the taxpayer may be entitled to a refund of federal employment taxes paid on the value of the spousal health coverage, and suggests that the taxpayer contact her employer to determine whether the employer is seeking a refund on her behalf. If the employer is not seeking a refund, the taxpayer may file Form 843 (Claim for Refund and Request for Abatement).

The letter confirms what many believed to be the case – employers are not obligated to automatically furnish corrected Forms W-2 to employees who had imputed income in years pre-*Windsor* for the value of employer-sponsored health coverage provided to same-sex spouses. However, it serves as a good reminder that employers should be prepared to respond to such requests as employees continue to seek refunds.

Of Mice and Elephants: *Halbig* and *King* and The Struggle of Two Federal Appeals Courts to Find Meaning in Words That May or May Not Be There

By Peter Marathas

- > At issue in *Halbig v. Burwell* and *King v. Burwell* is whether or not subsidies to buy insurance on an exchange are available in both state and federal exchanges. On its face the Affordable Care Act (“ACA”) provides for subsidies only in *state exchanges*. The Treasury Department wrote regulations in 2012, however, confirming that subsidies are available in both state and federal exchanges. Not so fast, said plaintiffs like those in *Halbig* and *King*: Treasury’s clarification looked a lot like legislating, which Treasury cannot do.

In *Halbig*, as has been widely reported, a three-judge panel of the D.C. Circuit Appeals Court determined that the absence of plain language in the ACA authorizing subsidies to individuals covered on federal exchanges meant no subsidies were available. In *King*, the Fourth Circuit Court of Appeals, while recognizing that there is no ACA language that explicitly authorizes the subsidies, found that that the “context” of the statute permitted subsidies in federal exchanges.

Who’s right and who’s wrong? I’ll leave that for a future court to decide. What’s interesting to me is how both courts allude to the same judicial doctrine to identify a weakness in the losing side’s case.

In *Halbig*, the majority notes that relying on a contextual reading of a definitional provision in an ancillary subsection of a major “operational” provision of the ACA would essentially transform the ancillary subsection into the “proverbial elephant in the mousehole.” In other words, it would be strange for Congress to hide an elephant (a key provision of the law) in a mousehole (an important but nonetheless ancillary provision of the law).

In *King*, a concurring judge wrote that the absence of a reference to the federal exchanges in the very same ancillary provision on which the *Halbig* court relied “bespeaks a deeply flawed effort to squeeze the proverbial elephant into the proverbial mousehole.” In other words it would be strange for Congress to override the intent of the statute by hiding a key provision (the elephant) in an ancillary subsection (the mousehole).

At the end of the day the use of the doctrine by both judges for different purposes bespeaks nothing more than the creative linguistics lawyers, judges and regulators use to justify different positions. The real elephant here is the elephant in the room: the fate of subsidies in over 30 states across the country. For employers, it’s an important elephant, since it is the subsidies (the mice?) that trip the penalties (the elephants?) under the ACA. Without subsidies there are no penalties. Should employers doing business in the states (including Washington, D.C.) operating state exchanges move to a federal exchange state? Of course not. In fact, the best course of action is to simply wait and see what develops and remember: with a resolute heart, a mouse can lift an elephant. I have no idea what that means in this context so I’ll leave it to each of you to apply it any way you see fit.

Our ERISA Litigation practice is a significant component of Proskauer's Employee Benefits, Executive Compensation & ERISA Litigation Practice Center. Led by Howard Shapiro and Myron Rumeld, the ERISA Litigation practice defends complex and class action employee benefits litigation.

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