ALERT

IMPORTANT EMPLOYEE BENEFIT DEVELOPMENTS

Part 3

October 1, 2008

This is the third in a three-part series of Alerts. As we stated in Parts 1 and 2, the employee benefit world has been very active and many of the legislative and regulatory changes could have a significant impact on your benefit plans. We have prepared this ALERT to highlight some of the more important developments.

This Alert is one page long. It contains a short list of topics we have chosen to highlight, along with a very brief explanation of each topic. We know you are very busy and the last thing you need is a long, drawn out legal analysis of complex topics that may not affect you. This Alert is intended to just highlight important new developments so you can quickly decide what may or may not apply to you.

Also enclosed with this Alert is a Memorandum that provides more detail on each topic. It will allow you to read a little more about the issues that affect you. It is also for those of you who are interested in understanding, in more detail, recent IRS and Department of Labor directives.

Here are some of the latest IRS and DOL developments that we feel employers should be aware of:

- **Proposed Cafeteria Plan Regulations.** New IRS Proposed cafeteria plan regulations are sched uled to take effect January 1, 2009. (However, since we are still waiting on the IRS to finalize these regulations, it is expected that the IRS will delay the effective date.) These regulations make numerous small changes, as well as a handful of major changes to the rules. Read the enclosed Memorandum to learn about the significant changes and clarifications in the new rules.

- **Final 403(b) Plan Regulations.** After many years of waiting, the IRS has at last issued final regulations for 403(b) plans. These rules affect employees of public schools and 501(c)(3) tax-exempt organizations. Some of the notable changes resulting from the final regulations are described in the enclosed Memorandum.

For those of you who would like to know more about these developments, we hope the enclosed Memorandum is useful to you. If you have questions about these developments or would like to discuss any of these topics in further detail, please feel free to call Eric Namee or Steven Smith at (316) 267-2000.

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October 1, 2008

MEMORANDUM

Important Employee Benefit Developments to Consider in 2008: Part 3

The employee benefits world has been very active over the past year. There have been numerous legislative and regulatory changes that have a significant impact on many employee benefit plans. This Memorandum is the third of a three part series intended to address what we view as some of the more important developments affecting our clients. It is certainly not intended to be a comprehensive analysis. What we have tried to do is pick out and highlight the changes that are most likely to directly affect the majority of our clients. We hope this is useful to you.

I. PROPOSED CAFETERIA PLAN REGULATIONS

In August 2007, the IRS issued proposed cafeteria plan regulations. These new regulations, which are scheduled to take effect January 1, 2009, affect all employers that allow employees to pay for health and welfare benefits with pre-tax dollars. The IRS has received hundreds of questions and comments on the proposed regulations from practitioners throughout the country. Although the proposed regulations are a step forward, they still leave many questions unanswered and have created many new ones. The IRS is expected to finalize the regulations later this year, and it is hoped that the IRS will be responsive to the comments it has received. It is also expected that the IRS will delay the effective date of the regulations. This is a topic where you are advised to "stay tuned."

As a reminder, cafeteria plans allow employers to offer certain benefits to their employees where the employee's premium or coverage costs are permitted to be paid by the employee on a pre-tax basis through salary reduction. Because these types of plans offer tax savings to employees and employers alike, employers must comply with certain rules in order to maintain the plan's "qualified" tax-favored status. A plan that does not follow the rules becomes "disqualified," the consequences of which include certain employee and employer contributions becoming taxable income to the employee.

The new proposed regulations changed and/or clarified many of the rules under which cafeteria plans must operate. The list below highlights some of the most significant changes:

- **Plan Document Requirement.** The new rules reiterate that a cafeteria plan must be in the form of a written plan document. They also clarify that the document must specifically describe all of the benefits, set forth the eligibility and participation rules, set forth rules for making an election, provide that all elections are irrevocable, state how employer contributions may be made under the plan, state the maximum amount of elective contributions, and state the plan year.

- **Qualified Benefits.** Cafeteria plans may only offer "qualified" benefits. Moreover, all cafeteria plans must offer a choice between at least one "qualified" (i.e. nontaxable) benefit and one taxable benefit. Taxable benefits include cash, benefits purchased with after-tax employee contributions, and paid time off. "Qualified" benefits include medical, dental, life, AD&D, health flexible spending accounts, dependent care assistance plans, HSA contributions, 401(k) contributions, and adoption assistance. Scholarships, education assistance, and long-term care insurance may not be offered through a cafeteria plan, even if paid for with after-tax employee contributions. The proposed regulations add long-term care services and deferrals to a 403(b) plan to this list of benefits that cannot be offered through a cafeteria plan.

- **Nondiscrimination Testing.** The cafeteria plan rules contain several nondiscrimination tests that must be run annually. Failure to document compliance with the nondiscrimination rules can result in the disqualification of a cafeteria plan. The new regulations make several changes to these rules. For example, they specify that the nondiscrimination test must be performed on the last day of the plan year. (Keep in mind that cafeteria plans, as well as health flexible spending accounts, dependent care accounts, group-term life insurance plans, and self-funded medical plans, are all subject to some type of nondiscrimination testing.) Employers must be able to document the testing and produce the results in case of an audit.

  The new regulations also create a safe harbor test for premium-only plans. The nondiscrimination tests that cafeteria plans must pass each year include an Eligibility Test, a Contributions & Benefits Test and a Key Employee Test. Under the new safe harbor, a cafeteria plan that offers as its sole benefit an election between cash and payment of the employee share of the premium for accident and health insurance is deemed to satisfy Code § 125 nondiscrimination requirements if it "satisfies the safe harbor percentage test for eligibility" under the regulations. In other words, the plan need not also conduct or pass the Contributions & Benefits Test or the Key Employee Test.

- **Group Term Life Insurance.** The IRS counts as taxable income a percentage of the cost of group term life insurance coverage in excess of $50,000. Prior to the issuance of the proposed regulations, imputed income on the excess amount was the greater of the "Table I" cost of the excess coverage or the actual premium paid with pre-tax salary dollars for the excess coverage. Under the new rule, Table I must be used for calculating taxable income on cost of coverage over $50,000. *This change is effective immediately.*

- **Plan Year.** A cafeteria plan must generally define what consecutive 12-month period is the "plan year." The plan year may only be changed for a valid business purpose. Through several examples, the new rules clarify what constitutes a valid business purpose (e.g., launching a new plan after the start of the plan year and changing to a new insurance carrier whose benefit year is different from the current year).

- **Elections for New Hires.** Under the cafeteria plan rules, once an employee makes an election under a cafeteria plan, the election is irrevocable unless one of the permitted election change events occurs. Generally, an employee must make his/her election prior to satisfying the plan's eligibility conditions. This caused problems for plans that allow new employees to participate as of the first day of employment. Many times it was administratively impossible for a new hire to sign the proper paperwork prior to starting work. Under the rules, the new hire was deemed to have elected not to participate in the plan for the year and could only change that election if a permitted election change event occurred.

The proposed regulations attempt to solve this problem. Under the new rules, a new employee may have 30 days after his/her date of hire to make an election, and that election will be effective retroactive to the date of hire. This rule does not apply to rehired employees. It is unclear how this rule will apply to dependent care spending accounts and health flexible spending accounts. It is expected that the IRS will clarify this rule when it finalizes the regulations.

- **Dependent Care Expenses.** The proposed regulations now allow an employee who terminates employment during the plan year to use funds set aside in his/her dependent care assistance plan ("DCAP") account to pay for qualified dependent care expenses that are incurred after his/her termination but prior to the end of the plan year. To take advantage of this provision, your cafeteria plan document would need to be amended to address this new rule.

- **Health Flexible Spending Accounts and Orthodontia.** The reimbursement of orthodontia expenses through a health flexible spending account (a "health FSA") has created problems for employers for years. The new proposed regulations permit employees to use money in their health FSA to pay for advance deposits for orthodontia, as well as for treatments that may not be performed until the following year. Employers do not have to allow for such reimbursements. However, whatever policy an employer chooses to follow should be applied consistently to all participants.

- **Severance Pay.** The proposed regulations make it clear that cafeteria plans may now allow terminated employees to pay COBRA premiums on a pre-tax basis with severance pay. If you do not currently allow COBRA premiums to be paid with pre-tax dollars and you would like to allow COBRA payments from severance pay, your cafeteria plan document will need to be amended to address this.

If you have kept your cafeteria plan document up-to-date over the years and are not interested in taking advantage of new, optional provisions, it is possible that you may not need to update your document for the regulations once they are effective. However, it is still important to review your plan document to ensure that it is in compliance with the new regulations. In addition, it may be a good idea to perform an internal audit of your plan and check for any fine tuning that is needed. If you do not have a plan document or have fallen behind in updating your plan, now is the time to get a plan document or to get your plan back into compliance.

II. FINAL 403(b) PLAN REGULATIONS

Section 403(b) plans are tax deferred retirement savings arrangements for employees of public schools and of 501(c)(3) tax exempt organizations. In July 2007, the IRS issued long-awaited final regulations for these arrangements.

The final regulations replace the existing 1964 regulations and incorporate nearly four decades of legislative changes to 403(b) plans, beginning with ERISA and running all the way through the Pension Protection Act of 2006. The new final regulations also include a number of revisions and clarifications to the proposed rules that were issued in 2004. Some of the most notable changes are as follows:

- **Written Plan Document.** The final regulations require that all 403(b) plans – regardless of whether ERISA applies to the plan – must be maintained pursuant to a written defined contribution plan document. This written document must contain all the material terms and conditions for eligibility, benefits, applicable limitations, contracts available under the plan, and the timing and form of benefit distributions. There are also optional features a plan may offer such as participant loans and hardship withdrawals.

- **Contracts.** All contracts purchased for an employee will be treated as a single contract. If any one of them fails to meet the requirements of 403(b), *all contracts* purchased for that employee will fail to qualify for tax deferrals.

- **Model Documents.** Under the final regulations, it is expected that employers, such as public schools, that offer multiple 403(b) plans from numerous vendors will adopt a single document instead of having a separate document for each vendor's plan. To address the concerns about the cost of preparing plan documents for public schools plans, the IRS recently issued a model plan in order to provide an inexpensive way of complying with the written plan document requirement. Caution should be used in utilizing the IRS model documents. There are many options and variables that need to be fully understood. In addition, due to the complexity of the rules, the IRS "one size fits all" approach may not fully satisfy every public school system's particular needs.

- **Plan Termination.** The 403(b) regulations now allow a plan sponsor to make distributions to participants upon a plan termination. To take advantage of this provision, the employer must not set up a successor plan within the 12 months beginning on the plan termination date and ending 12 months after the distribution of all assets from the terminated plan.

The final regulations are generally applicable to taxable years beginning after December 31, 2008. For virtually all employers, therefore, the effective date will be January 1, 2009. There are, however, several transition rules with later dates for certain provisions. There are also numerous other things to consider in complying with the final 403(b) regulations. Such details are beyond the scope of this Memorandum. However, we hope that this Memorandum serves as a reminder of the new regulations.

CONCLUSION

The world of employee benefits is constantly in a state of flux. The purpose of this Memorandum is to provide you with a very brief synopsis of some of the more important changes to employee benefit rules that may be of interest to you. It is not a comprehensive analysis or a list of every change that has taken place. Of course, you are always welcome to contact us at any time to discuss the design of your plan and whether any changes are appropriate in order to take advantage of new rules.

If you have any questions about anything discussed in this Memorandum, please feel free to call Eric Namee or Steven Smith at (316) 267-2000.