Avoid a Hidden Liability: Your U.S. Cafeteria Plan Needs a Checkup Now

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A Presentation by Osler's New York Employee Benefits Team:

Sandra Cohen, Moderator
Carol Buckmann
Heidi Winzeler

Osler, Hoskin & Harcourt LLP

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Why the New Regulations are So Important

- First comprehensive new guidance since the 1980's
- Affect most welfare benefit plans, including almost all medical plans
- Can operate as a "safe harbor" now, even though they are not proposed to be effective in 2008
- Severe penalties for noncompliance
- Probably signal new audit attention
- When finalized, regulations would be effective for plan years beginning on or after January 1, 2009
- Plan Sponsors may rely on the proposed regulations until the rules are finalized.

Why the New Regulations are So Important (con't)

- Compliance will take longer than you think, because it involves communications, forms and procedures, in addition to drafting good plan documents
- These rules will be the ONLY way to permit employees to choose between cash and nontaxable benefits without constructive receipt (current taxation for everyone)

Which Plans are Covered (You may be Surprised)

- Cafeteria plans got their name because they allow employees to choose from a menu of taxable and nontaxable benefits and be taxed only on taxable benefits they choose.
- However, plans subject to these regulations might not have “cafeteria” in their name.
- These regulations apply to:
  - Medical plans that allow employees to pay their premiums on a pre-tax basis (“POPs”)
  - Flexible spending accounts (“FSAs”)

Which Plans are Covered (You may be Surprised)

- Flexible benefit plans
- Reimbursement plans
- “Section 125 Plans”, named for the Internal Revenue Code section creating these plans
- Other plans that permit employees to choose between cash and benefits not subject to tax.
    - Potentially apply when negotiating employment agreements.

Benefits You Can Provide – “Qualified Benefits”

- Medical, including COBRA premiums under the employer’s plan or the plan sponsored by a different employer and premiums for individual policies, if not under FSA
- Dependent Care and Health Care Flexible Spending Accounts (“FSAs”)
- Group Term Life Insurance
- Short term and long term disability
- Accidental Death and Dismemberment (AD&D)
- Adoption Assistance
- Health Savings Account contributions
- Contributions to a 401(k) plan
- Domestic Partner Benefits under permissible plans
- Paid Time Off (taxable)

You must provide at least 1 taxable benefit, such as cash; and one nontaxable Qualified Benefit in the menu to be covered by regulations.

Prohibited Benefits

Your plan may not provide

- Scholarships
- Meals and Lodging
- Educational Assistance
- Long Term Care benefits
- Fringe Benefits
- Group Term Life Insurance for Family Members
- Contributions to a 403(b) plan
- Coverage to partners or independent contractors

Prohibited Benefits (con't)

If your plan provides any prohibited benefits, even on an after-tax basis, the entire plan is disqualified

- Could you be covering U.S. taxpayers in a non-compliant plan outside the U.S.?

Elections

Must be made in advance and irrevocable, except that:

- Retroactive elections are permitted for new employees within 30 days of hire. Contributions must come out of future compensation. No longer need to require a new employee to pay for retroactive coverage through after-tax contributions.
- Elections can be changed mid-year if there is a Change in Status Event, such as losing coverage under your spouse's plan

Default elections permitted for new or current employees

Elections and changes may be made electronically

Spouses and family members may not make their own elections.

An employee may elect benefits for an individual who is not a "tax code" dependent (such as a domestic partner) on an after-tax basis.

Special Rules

A large number of special rules are imposed on these plans in the Regulations and under the Internal Revenue Code. Some significant rules are:

- "Use it or Lose It" for FSAs
  - Unused benefits cannot be carried over to future years, except if there is a 2½ month "grace period" adopted by the Plan
- Dependent care benefits may now be used after employment terminates
- Substantiation of expenses required
- 12 month plan year required except if valid business reason
- Employers may use forfeitures to pay expenses, but can also keep them or give to participants

Special Rules

- Uniform Availability under FSA –
  - Entire elected amount must always be available to pay benefits, and can exceed amount contributed to date by employees
- Plan can't permit pre-tax election to pay medical premiums in lieu of 401(k) or pension distribution
- Dollar Limits applicable to non-taxable benefits, such as dependent care assistance, will apply IN ADDITION to the cafeteria plan rules.

Nondiscrimination Testing
New Rules and Traps for the Unwary

- No real guidance before, except for sketchy statutory language
- Many employers either weren't doing any testing, or were aggressively interpreting the Code
- Cafeteria plan testing applies <u>in addition</u> to testing required for individual benefits such as uninsured medical reimbursement plans, dependent care.
- New testing will be mathematical, similar to the qualified plan rules but with some important exceptions
- Safe Harbor for premium only medical plans (PoPs) if they have nondiscriminatory eligibility.
  - No other testing required.
- Safe Harbor for health benefits

Non-discrimination Testing (cont.) Traps for the Unwary

- Highly Compensated Employees are NOT defined the same way as under qualified plan rules – Separate Tracking Required
  - There is no exclusion for the first year of employment
  - Includes spouses and dependents
  - Qualified Plan Key Employee (Top Heavy) definition also used in concentration test (without 409A simplification)
- 3 Mathematical Tests Done Annually

  - <u>Nondiscriminatory Eligibility</u> – based on Code Section 410(b) classification test

  - <u>Contribution and Benefits Test</u> compares benefits for HCEs to benefits for NHCEs as a percentage of compensation

Non-discrimination Testing (cont.)
Traps for the Unwary

- Test may be done based on allocable contributions instead of benefits. (Resembles ADP testing).

- Key Employee Concentration Test –their nontaxable benefits can't exceed 25% of total nontaxable benefits.

- Similarly situated participants must have uniform election opportunities.
- Rules applied on a controlled group basis.
- Although these look like the rules for tax qualified plans, plan sponsors need to learn the differences.
- If plan fails, highly compensated employees (or Key Employees) are taxed on the highest value of benefits they could have elected.

Written Plan Requirements

- Need to satisfy to get the tax benefit
- Plan must be adopted and effective on or before the 1st day of the plan year
- No concept of substantial compliance
- Need for legal review and careful drafting
- Every plan must state that it covers only employees
- Every plan must contain:
  - descriptions of benefits
  - rules for participation, elections and contributions
  - the Special Rules for health care, dependent care, adoption assistance FSAs, including “Use It or Lose it”, Uniform Coverage

Written Plan Requirements (con't)

- provisions for contributions or distributions to a Health Savings Account, if offered
- A description of any grace period under the plan

Leaving out required terms, or failing to follow them in operation, disqualifies the whole plan – everyone is affected!

Consequences of Not Complying: Taxes and penalties

- No voluntary compliance program for cafeteria plans
- Regulations set out a “zero tolerance” policy for mistakes
- One wrong move could subject employees to tax as if they have elected all cash
- Employers could be subject to penalties for failure to withhold income tax and FICA
- Failure to pass discrimination testing causes Highly Compensated Employees/Key Employees to be taxed on highest value of benefits available, even if the plan satisfies all the other requirements
- Could failure cause 409A problems?

Employee Communications

- Good communications will be part of compliance program
- Employees need to understand the rules in order to follow them
- Dangerous to pass on booklets drafted by insurers or TPAs without legal review
  - Should clearly describe restrictions and limitations on elections and benefits
  - Don’t assume these booklets satisfy plan requirements.

2008 Action Plan

- Determine which plans are subject to the regulations
- Review plans and agreements with employees for compliance. If you just have booklets, plan documents should be created.
- Review operations and communications for consistency with new plan rules
- Develop discrimination testing procedures on a controlled group basis
- Develop recordkeeping procedures
- Set-up separate tracking of highly compensated employees and key employees
- Decide whether to comply with the regulations early
- Be on the lookout for problems in mergers and acquisitions

Special Issues for Mergers and Acquisitions

- Need for due diligence
- Need to observe the rules when providing for post-closing cafeteria plan coverage
- Don’t create a non-compliant plan when negotiating benefits

Essentials to Take Away from this Program

- The regulations are long and very complex-review will take time
- Immediate review is URGENT for those who:

  -have no formal plan documents

  -haven't had a recent legal review of their plans

  -have never done discrimination testing

Essential Take Aways (cont.)

- This is also a good time to consider adding optional provisions to your plan, since you will be revising documents and communications anyway. In particular, think about:

  - Putting in a grace period

  - Debit cards

  - Funding disability benefits with after-tax contributions

  - Adding COBRA premiums

  - Allowing claims for unused dependent care benefits after termination of employment

- Think of these rules when doing due diligence in mergers and acquisitions, and in negotiating future benefits for acquired employees.

Osler New York Contacts

- If you have additional questions, or simply want to be added to our employee benefits mailing lists, please contact one of us:
- Sandra Cohen (212) 991-2508

  Sandra.Cohen@osler.com
- Carol Buckmann (212) 991-2581

  cbuckmann@osler.com
- Heidi Winzeler (212) 991-2559

  hwinzeler@osler.com