

## **Cafeteria Plan Next Steps**

**October 14, 2008**

The Department of Treasury issued comprehensive proposed regulations last year updating a broad range of issues affecting cafeteria plans. We anticipate that the proposed regulations will be issued in final form later this year and that the final regulations will have a delayed January 1, 2010 effective date. Even though the final regulations have not yet been released, there are a number of steps that employers can take now as they finalize their 2009 plan design and begin thinking about design features for 2010. This LawFlash briefly describes suggested next steps employers should take to position their cafeteria plans for the final cafeteria plan regulations.

### **Next Steps**

In general, we anticipate that most employers will postpone significant plan document changes but should compare their 2009 cafeteria plan design and administration against the proposed regulations.

### **Plan Document**

All plan documents will need to be revised to deal with the cafeteria plan regulations. Since the proposed regulations will likely change when they reach their final form, few employers are devoting the resources to revising their cafeteria plan documents in advance of the final regulations.

Employers should, however, update their plan documents if they do not yet describe benefits that are currently offered to participants, have not documented a grace period for the medical spending account, or do not describe pre-tax or rollover contributions to a health savings account (HSA). The final regulations will likely state that such benefits cannot be offered until after the underlying plan documents are adopted or revised. As a result, employers are taking the interim step of making sure that nothing significant is missing from their current documents and will argue that adopting these changes before the issuance of the final regulations avoids jeopardizing the tax effectiveness of their current benefits.

### **Design vs. Regulations**

While it is too early for most employers to completely revise their plan documents in anticipation of the final regulations, employers should review their 2009 cafeteria plan design and anticipated 2010 changes against the proposed regulation language.

Suggested topics are:

- Final nondiscrimination rules will prize, above all, uniformity in benefits and pricing. Employers should ensure, except where necessary due to geography or profit structures, that all employees have the same benefits available at the same pricetags. The ideal cafeteria plan will cover all but the youngest or shortest service employees and not have any variation in pricetags or employer credits. To the extent that there is variation, employers will have to be prepared to justify these variations using a stand-alone plan document. To the extent that highly paid employees receive benefits at a lower cost/higher subsidy, employers should prepare to move them into the plan that the balance of employees participate in and, if necessary, to increase their pay if there is a need to make them whole.
- The level of employer subsidies for medical coverage will determine whether the employer has to perform complicated nondiscrimination tests. In general, medical benefits that receive a 75% or greater employer subsidy will escape complicated nondiscrimination testing. As a result, any employer whose level of subsidy is nearing or below 75% of the cost of the coverage should reconsider whether the cost savings will be worth the additional nondiscrimination testing.
- Employers should also examine which benefits are available through their cafeteria plan. The proposed regulations reiterate the usual impermissible benefits (such as long-term care coverage) but throw in a few additional wrinkles such as spouse or dependent life insurance purchased on an after-tax basis. If a cafeteria plan still contains these now-impermissible benefits for 2009, employers should examine how and where to document these benefits (such as, perhaps, in a wrap welfare plan) and whether it makes sense to continue to impose midyear change rules on these benefits.
- Check to be certain that payroll processes are accurately calculating imputed income for group term life insurance. The proposed regulations state that imputed income should be calculated on Table 1 rates instead of the historic greater of Table 1 or actual cost approach. This change is already effective, but some employers still have not yet made the payroll system change and are, as a result, overstating imputed income related to group term life insurance.
- Employers should check to determine if their payroll processes are resulting in participants paying for retroactive coverage on a pre-tax basis. This is generally impermissible under the proposed rules (absent one 30-day window in limited circumstances or due to FMLA catch-up payments) and practically results in employers giving away retroactive coverage (or charging on an after-tax basis) for individuals who wait as long as possible to enroll or experience a retroactive change in status.
- Determine that your spending account administrator is correctly handling the substantiation requirements of the proposed regulations and, further, can satisfy the special rules that apply to any debit cards. Employers should specifically ask the vendor about this capability and also obtain an indemnification regarding their compliance.
- Be certain that any electronic communications or elections satisfy the qualified plan electronic transaction safe harbor.

- Imbed statements in the 2009 employee communication material indicating that the plan is subject to nondiscrimination rules that may reduce or limit the tax advantages of the plan for certain employees. Similar language may already appear in communication material surrounding the dependent care spending account 55% utilization test. This language will give employers the ability to react to any unpleasant nondiscrimination requirements in the final regulations (such as the proposed utilization test that compares high-paid to low-paid elections) by treating some of the high paid pre-tax contributions as taxable income.

For more information on the cafeteria plan regulations, and to discuss next steps related to your 2009 and 2010 cafeteria plan design, please contact one of the following Morgan Lewis attorneys:

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