GROOM LAW GROUP, CHARTERED

2007 Employee Benefits Seminar

IRS Regulation Update

Presenters: **Lou Mazawey (Moderator)**
Chris Keller
David Levine
David Powell

Topics: **Section 415 Rules**
Cafeteria Plans
Tax Deferred Annuity Regulations
End-of-Year and 401(k) Pension Compliance Issues

Materials: **Presentations**
IRS Updates, Expands and Restructures Long-Standing Proposed Regulations
End-of-Year Plan Amendment and PPA Cash Balance Issues

Highlights of the New Proposed Cafeteria Plan Regulations

Christine L. Keller

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Introduction

- The IRS re-proposed cafeteria plan regulations from 1984 and 1989 in an updated and expanded form (Aug. 2007).
- Once final, all requirements, including those that are restrictive or administratively burdensome, will be given high deference by a court.
- Public comment period is open now (comments due 11/5/07).

Effective Date

- The proposed effective date for these regulations is plan years beginning on or after January 1, 2009 for all provisions except:
  - group-term life insurance (effective 8/6/07); and
  - debit card provisions (effective as described in previous IRS debit card guidance).

Employer/Administrator "To Do" List

- Submit written comments to IRS.
- Review and possibly amend written plan documents.
- Review and possibly amend administrative practices, including election procedures.
- Review nondiscrimination testing practices.

New Rules

- New written plan requirements
- Coverage for non-spouse/non-dependent addressed
- Reimbursement of individual accident and health premiums permitted
- Severance payments may be reduced pre-tax
- New rule regarding group-term life coverage
- New hires: 30 day retroactive coverage permitted
- Employer must permit change in HSA election monthly
- New Health FSA rules, including “orthodontia” exception

Top Issues

- No retroactive amendments permitted
- Definition of operational failure very broad
- Nondiscrimination rules still not clear
- No correction program
- No de minimis exceptions
- No guidance regarding changing of election due to “mistake”
- Debit card rules are incorporated

Final Regulations Under IRC § 415 – Key Issues

Lou Mazawey
Groom Law Group, Chartered

Employee Benefits Seminar

October 24, 2007

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- Update current regulations for changes over the last 25 years
- Generally effective for limitation years on and after July 1, 2007
- Plan amendments generally required for 2008 limitation year (2008 tax filing deadline for calendar-year plans)

- § 401(a)(17) limits the compensation that is used to apply § 415; however, grandfather rule protects benefits accrued prior to effective date
- Foreign compensation/nonresident aliens issues resolved favorably
- Multiemployer and multiple employer plans required to apply § 415 on a plan-wide basis

- Multiple annuity starting dates – new proposed regs being developed
- COLAs generally tested as they come into effect
- Various clarifications/changes to rules regarding plan aggregation, rehired and short-service employees, benefit transfers, rollovers, and terminated plans

- 415 corrections made under EPCRS
- Private DB plans must apply limits as benefits accrue/governmental and church plans may limit only at payout
- “Restorative payments” not annual additions
  - Payments made to restore plan losses due to risk of liability for breach of fiduciary duty (ERISA or other federal/state law), including, DOL or court-approved settlement, and payment under DOL’s VFCP

- Limits on ability to characterize payments as "restorative" – e.g., reimbursements for losses due to market fluctuations, transfers at less than market value, do not qualify

- "Post-Severance" Compensation

General rule – amounts included if paid or made available during limitation year and before severance from employment

- Limited inclusion of post-severance compensation
  - Amounts that would not have been paid if employee had remained employed are expressly excluded – e.g., severance pay
  - Certain post-severance compensation included
    - Post-severance employee pay counts only if paid by the later of 2 ½ months after severance from service or by the end of limitation year in which severance from service occurred

- Only then if payments would have been made if employee had continued in employment, e.g., regular wages, overtime, commissions, bonuses
- Payments for accrued bona fide sick, vacation, or other leave, if employee would have been able to use the leave had employment continued
  - Included only if plan includes
  - May count timely payout of nonqualified deferred compensation

- What is “severance from employment”?
  - “Ceases to be an employee of the employer”
  - “Employer” group determined on 50% ownership basis
  - No severance from employment where new employer maintains the plan
- 401(k) and 457 regs revised to permit elective deferrals only from 415 compensation
- Special rule for USERRA military service
- Special rule for SS disability

The Final 403(b) Regulations: A Few Months' Perspective

David W. Powell

Overview of Final Regs

- Plan document required
- Employer must administer like a plan
- Employer may delegate administrative duties
- New transfer / exchange rules

The Big Problems:

- Effective date and transition
- Slow demise of Rev. Rul. 90-24 and its effect on exchanges

Final Regs Generally Effective 1/1/09

- Church Plans – first plan year after 12/31/09
  - But there is a catch: applies where "authority to amend the plan is held by church convention"
- No general governmental plan delay
- But there is a CBA delay for CBAs ratified and in effect on 7/26/07
  - Earlier of 7/26/2010 or termination of CBA
  - Will help a lot of governmental (school district) plans because subject to CBA

Demise of Rev. Rul. 90-24

- 90-24 allowed contract to contract transfers
- IRS did not like that it caused contracts to "leave" plan administration
  - Audits indicated very little tax compliance
- Not actually revoked yet, BUT: final regs will <u>not</u> apply to contracts subject of 90-24 exchanges before 9/25/07

Transfers and Exchanges Still Allowed (Subject to new rules)

- Exchanges – within plan
  - Must be subject to "information sharing agreement" (ISA)
    - As "necessary" to allow plan to aggregate contracts for compliance
    - Such as loans, hardships, whether a severance has occurred
- Transfers – plan to plan
  - Similar to 401(a) to 401(a) plan to plan transfers

Exchange Issues

- What if a contract is exchanged after 9/24/07 and there is no ISA by 1/1/09?
  - Disqualification?
  - Does it matter if previously exchanged?
  - Can it be corrected before 1/1/09?
  - What is the effect on the plan?

Exchange Issues (cont.)

- What has to be in an ISA?
  - Employers may want providers to administer
  - Providers may want employer or TPA to administer
  - Privacy concerns?

Orphan Contracts

- What if there are old contracts out there that the employer is unaware of on 1/1/09
  - Contract disqualified?
  - Failure to follow plan document?
  - Note: 9/24/07 grandfather does not technically apply to contracts never the subject of 90-24 exchanges

What are Employers and Providers Doing:

- Providers:
  - Some not taking 90-24 transfers because not intending to be part of a plan
  - Some are taking transfers if employer executes an ISA (or an agreement to enter into an ISA by 1/1/09)
- Employers:
  - Some not signing anything. Waiting.
  - Many have not thought it through

We're Expecting More Guidance

- Told it will be out by 10/31/07
- Should address 90-24 transfers before and after 9/24/07 and transition to 1/1/09
- Should provide guidance on ISAs
- Should be in conjunction with model plan language

The Trends

- Difficult to see how employers can comply with final regs by 1/1/09 without going to
  - A single provider who will act as administrator; or
  - A TPA who will administer multiple providers
- "Any willing provider" likely to become rarer
- Employer (especially school district) expectations of provider services may come into conflict with what providers are willing to do by 1/1/09

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MEMORANDUM

August 20, 2007

IRS Updates, Expands and Restructures Long-Standing Proposed Cafeteria Plan Regulations

On August 6, 2007, the Internal Revenue Service ("IRS") completed the first phase of its overhaul of proposed cafeteria plan regulations originally published in 1984 and 1989, by re-posing the regulations in an updated and expanded form. 72 Fed. Reg. 43938 (Aug. 6, 2007). The new proposed regulations reflect an effort by the IRS to address and clarify many of the questions that have been raised by the public since the original proposed regulations were published. Indeed, these regulations collect, in one document, many of the rules and principles articulated by the IRS through formal and informal guidance issued over the past two decades. However, the cost of this clarity is that once these proposed regulations become final, all of these requirements, including those that are restrictive or administratively burdensome, will be given high deference by a court. Therefore, the public comment period provided for under these regulations is particularly important, because it may mark the last time that the public will be given a meaningful opportunity to shape the IRS's interpretation of the law in this area. Written or electronic comments must be received by November 5, 2007, and the IRS will hold a public hearing on November 15, 2007 (outlines for hearing topics must be submitted by October 25, 2007).

To conform to these regulations, employers and third-party administrators will need to review and possibly amend written plan documents and administrative practices, including election procedures and nondiscrimination testing. With two exceptions, the proposed effective date for these regulations is plan years beginning on or after January 1, 2009.[1] Below, we summarize the most significant changes in these regulations and highlight certain areas in which we think that the IRS should be urged to clarify or change its position.

I. New Written Plan Requirements

A. Generally

The statute itself under section 125 of the Internal Revenue Code ("Code") provides that a cafeteria plan must be in writing, and IRS regulations specify what information the written plan document must contain.[2] The new proposed regulations have expanded the written plan

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[1] The regulatory provisions relating to group-term life insurance are immediately effective (8/6/07), and the regulatory provisions relating to debit cards are effective as described in previous IRS debit card guidance.

[2] Although the IRS does not review cafeteria plan documents and issue determination letters as it does for Code section 401(a) qualified retirement plans, on audit, the IRS would expect an

requirements to include additional information. Significantly, these regulations state that if there is no written cafeteria plan, or if the written plan fails to satisfy any of these requirements, the plan is not a cafeteria plan and an employee's election between taxable and nontaxable benefits results in gross income to the employee.

Under the previous proposed regulations, a cafeteria plan document was required to include a description of all available benefits under the plan as well as the periods of coverage, the plan's rules governing participation and eligibility, the procedures governing employee elections, the manner in which employer contributions may be made under the plan, the maximum amount of employer contributions available to any employee under the plan, and the plan year. The new proposed regulations contain these requirements, and, in addition, require that the written plan contain:

- a statement that only employees may participate in the plan;
- a statement that plan provisions apply uniformly to all participants;
- for flexible spending arrangements ("FSAs"), a description of the rules that apply to those arrangements (e.g., for health FSAs, the uniform coverage rule and the use-or-lose rule);
- for Health Savings Accounts ("HSAs"), the ability to elect to make salary reduction contributions to an HSA, to change such election prospectively at any time, and if applicable, the ability to transfer FSA funds to an HSA;
- a description of the "paid-time off ordering rule" if applicable (described below); and
- a description of the grace period if applicable (described below).

The new proposed regulations also clarify that the plan year must consist of at least 12 consecutive months, and may be changed only for a valid business purpose.

✓ ***Action Item*: *Review cafeteria plan documents to determine if amendment is necessary due to new requirements. Consider providing comments to the IRS requesting a de minimis exception to the rule that any plan document omission causes taxation for all participants, particularly in light of the IRS position (described below) that no cafeteria plan amendment may be made retroactively.***

B. Paid Time Off

The previous proposed regulations provided that permitted taxable benefits offered under a cafeteria plan could include various forms of paid leave, referred to as "vacation days." The new proposed regulations expand this rule to include vacation days, sick leave and personal days, which are now referred to collectively as "paid time off." As with the previous proposed regulations, an employer may offer elective, paid time off under a cafeteria plan. However, those days may not be carried over from one year to the next because this would be an impermissible deferral of compensation. The days may, however, be cashed out before the end

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employer to be able to produce a written cafeteria plan that satisfies the requirements specified in the regulations.

of the plan year, without regard to any grace period that may be available. For this purpose, a participant is deemed to use non-elective paid time off before elective paid time off days. The plan document is now required to describe this "ordering rule" if paid time off is offered under the plan.

✓ ***Action Item*: *If the employer offers participants the ability to purchase paid time off, employers must amend the written cafeteria plan to include the required ordering rule for use of non-elective and elective paid time off no later than the first plan year beginning on or after January 1, 2009.***

C. Grace Period & Run-Out Period Requirements

The new proposed regulations incorporate guidance issued under prior IRS Notices regarding cafeteria plan grace period requirements. Notice 2005-42 permits an employer to offer a grace period not to exceed 2½ months immediately following the end of each plan year during which plan participants can continue to incur expenses for qualified benefits (e.g., medical expenses that will be reimbursable under a health FSA). Additionally, Notice 2005-86 provides guidance on eligibility to contribute to a HSA during the cafeteria plan grace period, and Notice 2005-61 provides guidance on the availability of a grace period for dependent care assistance.[3] The new proposed regulations add a new requirement. Now, in order to incorporate a grace period into a cafeteria plan, language must be added to the grace period provision in the written plan document to provide that any unused benefits or contributions from the preceding plan year that exceed expenses incurred during the grace period may not be carried forward to a later plan year, may not be cashed-out, and must be forfeited under the use-it-or-lose-it rule. The new proposed regulations also provide that employers may also use a run-out period after the end of the plan year or grace period during which participants may submit reimbursement claims for expenses incurred during the plan year or grace period, so long as the run-out period applies uniformly and consistently to all participants.

✓ ***Action Item: If the plan includes a grace period, employers must amend the written plan to include provisions complying with the grace period rules no later than the first plan year beginning on or after January 1, 2009. Also, employers should review claims reimbursement practices to verify that the run-out period is administered in the same manner for all participants. Consider providing comments to IRS requesting clarification that the run-out period need not be identified in the written plan document in order to be used.***

D. Written Plan Requirement Under Code § 125 Satisfies Other Code Sections

Generally, the Code requires that a self-insured medical reimbursement plan, dependent care assistance program, and adoption assistance plan be described in a written plan document. The new proposed regulations provide that where these programs are offered through a cafeteria plan satisfying the cafeteria plan document requirements, the description of such programs in the cafeteria plan also satisfies the written plan requirements pursuant to each program's applicable

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[3] Notice 2005-86 was modified by section 302 of the Tax Relief and Health Care Act of 2006.

Code section. Alternatively, these programs could be described in separate written plans rather than as part of the cafeteria plan.

✓ ***Action Item: Review existing plan documents for self-insured health plans, dependent care assistance programs and adoption assistance programs to determine whether such documents adequately describe these benefits. If not, consider incorporating a description of such benefits into the cafeteria plan document for administrative convenience.***

E. Effective Date of Amendment to Cafeteria Plan

The new proposed regulations state that although a cafeteria plan is permitted to be amended at any time during a plan year, the amendment is only permitted to be effective for periods after the later of the adoption date or effective date of the amendment. Presumably, the IRS would take the same position with respect to the complete restatement of a cafeteria plan. This rule did not appear in the previous proposed regulations, but is consistent with the IRS position that a plan cannot be retroactively adopted. See American Family Mutual Insurance Co. v. U.S., 815 F. Supp. 1206 (W.D. Wis. 1992). Nevertheless, the IRS should provide some flexibility to allow employers to permit certain types of cafeteria plan amendments to be made retroactive to the first day of the current plan year (e.g., amendments to correct plan document omissions or errors).

✓ ***Action Item**: Consider providing comments to the IRS seeking a rule allowing certain types of amendments or restatements to be retroactive to the beginning of the same plan year, such as amendments to correct plan document omissions or errors.*

II. Plan Operational Failures

The new proposed regulations broadly state that any failure of a cafeteria plan to operate in accordance with the written document, section125, or the regulations will result in the plan failing to be a cafeteria plan. Without a cafeteria plan, if an employee were given a choice between cash and a nontaxable benefit, that employee would be required to include the value of the cash in income, even if he chose the nontaxable benefit. The new regulations also include several examples of plan operational failures. For instance, the new regulations provide that when employers offer benefits other than permitted taxable and qualified benefits, an operational failure occurs and the plan is not a cafeteria plan. Additionally, when the plan fails to comply with the uniform coverage rule, the substantiation requirements, or operates to defer compensation except as specifically permitted under the new proposed regulations, section 125 does not apply to the plan and the plan is not a cafeteria plan. The new proposed regulations contain no exceptions for minor or isolated violations of the written plan terms, section 125, or the regulations, and no indication that retroactive correction is possible.

✓ ***Action Item**: Urge the IRS to clarify the regulations as follows:*

- ***When an operational failure occurs with respect to only a single employee, the plan fails to be a cafeteria plan only with respect to the single employee, and not all employees under the plan.***

- ***De minimis operational failures do not result in the plan not being a cafeteria plan.***

- ***A limited period to retroactively correct cafeteria plan administrative mistakes, including mistakes regarding impermissible election changes, ineligible benefits, and impermissible participants is permitted.***

III. Only Employees Eligible for Coverage

Consistent with Code section 125(d)(1)(A) and the previous proposed regulations, the new proposed regulations provide that only employees are eligible to participate in a cafeteria plan. The new proposed regulations clarify that the term "employee" includes a common law employee, a leased employee (Code section 414(n)), a full-time life insurance salesman (Code section 7701(a)(20)), and a current or former employee. The new proposed regulations also clarify that self-employed individuals (including a director solely serving on a corporation's board of directors and not otherwise providing services to the corporation as an employee), partners, and shareholders in S-corporations who hold more than 2% of stock are not permitted to participate. In addition, although spouses and dependents of employees may not directly participate in a cafeteria plan, these individuals may receive coverage if the employee chooses to participate. Finally, former employees may participate in a cafeteria plan, but a cafeteria plan may not be established predominantly for the benefit of former employees. The new proposed regulations clarify that an individual who provides services to an employer as both an employee and as an independent contractor (dual status individual) may participate in the cafeteria plan in his or her capacity as an employee.

A subject of some uncertainty in the past has been whether employees of a more than one employer could participate in the same cafeteria plan. The IRS has specifically requested comments in these new proposed regulations regarding this issue.

✓ ***Action Item***: ***Review the eligibility provisions of the cafeteria plan document to verify that only employees are eligible. Confirm that any dual status individual participates only in the capacity of an employee (i.e., income earned as an independent contractor may not be reduced to pay for qualified benefits). Consider providing comments to the IRS allowing multiple employers who are not part of a common control group to sponsor a single cafeteria plan.***

IV. Group Term Life Insurance

Under Code section 79, an employer may provide up to $50,000 of group-term life insurance coverage on an employee without having to include any of the cost of that coverage in the employee's gross income. A cafeteria plan may offer coverage in excess of $50,000, but the cost of group-term life insurance coverage in excess of $50,000 must be included in the

employee's income. The new proposed regulations contain a new and simplified rule for calculating the cost of group-term life insurance coverage in excess of $50,000.

Under previous IRS guidance (Notice 89-110), when group-term life insurance coverage exceeded $50,000, the employer was required to include in the employee's gross income the greater of the cost of the excess coverage as determined under the Code section 79 regulations (Table I), or the employee's pre-tax contributions toward the purchase of the excess coverage. The new proposed regulations simplify this rule and provide that the amount taxable to the employee is now based only on the cost of the excess coverage as determined under Table I. This is a favorable change that became effective on August 6, 2007.

✓ ***Action Item*: *Modify the method used to impute income to employees who receive group-term coverage in excess of $50,000 to reflect the Table I rate.***

V. Coverage for Non-Spouse/Non-Dependent

The new proposed regulations discuss an employee's ability to elect benefits for an individual who is not an employee's spouse or dependent, such as a domestic partner, through the employer's cafeteria plan. The new regulations make clear that an employee must elect coverage for an individual other than a spouse or dependent on an after-tax basis, which means that the fair market value of the coverage must be included in the employee's gross income. "Dependent" for purposes of a cafeteria plan is generally defined under Code section 152, but is modified to the same extent the definition is modified for the underlying benefit. For example, with respect to health coverage, the definition of dependent under Code section 152 does not apply a gross income limitation, or take into account whether the dependent is married or has his/her own dependents.

✓ ***Action Item*: *Determine whether coverage is provided under the employer's cafeteria plan to individuals who do not satisfy the definition of a spouse or dependent of an employee. If so, impute the fair market value of such coverage to the employee's income. Consider providing comments to the IRS requesting clarification concerning what the IRS considers an acceptable measure of fair market value, such as the COBRA individual rate that would be charged for continued participation in a health plan.***

VI. Payment or Reimbursement of Individual Accident and Health Plan Premiums

The new proposed regulations clarify that a cafeteria plan (but not a health FSA) may pay or reimburse substantiated individual accident and health insurance premiums, and employees may exclude employer reimbursements or payments for such individual premiums from gross income. The new proposed regulations specifically permit employer payments and reimbursements to be made in one of three ways: directly to the employee upon substantiation of the payment of premiums, by issuing a check payable to the employee and the insurance company jointly, or by issuing a check to the employee for the amount of the premium, which the employee is obligated to turn over to the insurance company. The inclusion of this rule in the new proposed regulations is a favorable development. However, the rule, which is based on a

revenue ruling from 1961 (Rev. Rul. 61-146), needs to be updated. For example, the regulation does not indicate whether an employer may make payment via electronic transfer of funds from the employer to the insurer or other entity. Also, the regulation does not clearly indicate that an employer's cafeteria plan can allow an employee to pay for individual coverage obtained through a state entity like the Massachusetts Connector.[4] Finally, the regulation does not indicate whether coverage that an employee's spouse or dependent obtains independently from the employee could be reimbursed under the employer's cafeteria plan.

✓ ***Action Item*: *Consider requesting that the IRS update the individual coverage section of the regulation to authorize electronic fund transfers, to indicate that health coverage purchased through a state entity is a qualified benefit, and to clarify that coverage obtained by a spouse or dependent may be reimbursed through the employer's cafeteria plan.***

VII. Salary Reduction

The new proposed regulations prohibit an employee from reducing qualified retirement plan distributions on a pre-tax basis to pay for qualified benefits under the cafeteria plan, consistent with an IRS revenue ruling addressing this issue (Rev. Rul. 2006-62). However, the regulations do provide that severance payments may be reduced to pay for qualified benefits under the cafeteria plan on a pre-tax basis, consistent with a long-standing informal IRS position. Historically, the IRS has also taken the informal position that long-term disability benefits may be reduced to purchase qualified benefits under a cafeteria plan on a pre-tax basis, but there is no mention of this in the regulations.

The IRS has specifically requested comments on whether salary reduction contributions may be based on employees' tips and how that would work.

✓ ***Action Item*: *Consider amending the cafeteria plan and severance plan to allow former employees to reduce severance benefits to purchase qualified benefits under the cafeteria plan on a pre-tax basis. Also, consider requesting that the IRS expand this rule to include other types of payments provided to former employees, such as long-term disability benefits, which could similarly be reduced to purchase qualified benefits on a pre-tax basis. Consider providing comments to the IRS requesting that the IRS allow salary reduction contributions based on employees' tips.***

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[4] The Massachusetts Health Care Reform Act requires employers with 11 or more Massachusetts employees to establish and maintain a Code section 125 cafeteria plan for all employees who meet certain criteria, including all Massachusetts employees who work at least 64 hours per month (equivalent to 16 hours per week). The employer is not required to provide or contribute to health coverage for these employees, but must allow these employees to purchase health coverage on a pre-tax basis through the employer's cafeteria plan. Many employers are choosing to offer employees who do not satisfy the eligibility requirements under the employer's group health plan the option to elect coverage through the Massachusetts Connector and to pay for this coverage on a pre-tax basis through the employer's cafeteria plan. Other states (Connecticut, Missouri, and Rhode Island) have recently enacted similar laws.

VIII. Deferred Compensation

The new proposed regulations, consistent with the previous proposed regulations, provide that if an unused elective contribution, an after-tax contribution, or a plan benefit carries over from one plan year to the next, a deferral of compensation has occurred. Generally, a plan that provides for the deferral of compensation fails to be a cafeteria plan, causing all elections to result in gross income to employees.

The new proposed regulations identify specific benefits and practices that do not operate to defer compensation. These include a long-term disability policy paying disability benefits over more than one year, reasonable premium rebates or policy dividends, certain advance payments for orthodontia, vision or dental insurance requiring a mandatory two-year coverage period, and the use of salary reduction amounts from one plan year to pay accident and health insurance premiums for the first month of the immediately following plan year.

The new proposed regulations additionally clarify that certain features or benefits of accident and health insurance policies that apply for more than one plan year do not defer compensation. These include credit toward the deductible for unreimbursed covered expenses incurred in prior periods, reasonable lifetime maximum limits on benefits, level premiums, premium waiver during disability, guaranteed policy renewability of coverage, and progressive diagnosis payments. The regulations provide, however, that accident and health insurance policies applying for more than one plan year may not provide an investment fund or cash value reserve used to pay future policy premiums, and no part of the premium may be held in a separate account for the beneficiary.

✓ ***Action Item*: *Review current benefits and practices to verify that there are no benefits or practices that could be considered to defer compensation within the meaning of the new proposed regulations. Consider requesting that the IRS recognize additional exceptions to deferred compensation, such as advance payments for other types of medical expenses (e.g., pre-natal care).***

IX. Non-Qualified Benefits

The new proposed regulations identify those benefits that are not permitted to be provided as part of a cafeteria plan. These include scholarships, employer-provided meals and lodging, educational assistance, fringe benefits, long-term care insurance, long-term care services, group-term life insurance on the life of any individual other than an employee, health reimbursement arrangements, contributions to Archer MSAs and elective deferrals to a section 403(b) plan.

It is common practice to describe non-qualified benefits in a cafeteria plan document for purposes of administrative convenience. For example, dependent care life insurance or certain fringe benefits are often described in a cafeteria plan document, with a statement in the document indicating that such benefits are not part of the cafeteria plan. However, the regulations do not indicate whether it is possible for a benefit to be described in a cafeteria plan document without being considered part of the cafeteria plan.

✓ ***Action Item*: *Review benefits described in cafeteria plan to verify that there are no benefits that could be considered "non-qualified benefits" under the cafeteria plan within the meaning of the new proposed regulations. Consider requesting that the IRS clarify whether non-qualified benefits could be described in a cafeteria plan document for purposes of administrative convenience, as long as the document identifies which benefits are and are not considered part of the cafeteria plan.***

X. Election Rules

Consistent with previous proposed regulations, the new proposed regulations generally require cafeteria plan elections to be made before the earlier of the first day of the plan year (or period of coverage) or the date the taxable benefits would currently be available. The new rules permit such election changes to be made electronically by an employee. The safe harbor under Treas. Reg. § 1.401(a)-21 applies to electronic elections, revocations and changes in elections under section 125.

The new proposed regulations contain a new rule regarding salary reduction elections with respect to an HSA. The new rule provides that if a cafeteria plan offers HSA contributions as a qualified benefit, the plan must allow a participant to prospectively make, change or revoke salary contribution elections for HSA contributions before salary becomes currently available on at least a monthly basis. Previous IRS guidance allowed an employer to adopt this rule, but did not require it.

The new proposed rules additionally permit new employees to make elections between cash and qualified benefits within 30 days after their hire date. The new rules provide that the election is retroactive to the new hire date, and salary reductions for the election must be made from compensation not yet available on the date of the election. An employee is ineligible for this election when such employee terminates employment and is rehired within 30 days, or returns to employment after an unpaid leave of absence of less than 30 days. Where the employer allows new employees to make this election, the written plan is required to provide for these rules.

Finally, the new proposed regulations incorporate previous IRS guidance regarding automatic elections (Rev. Rul. 2002-27), providing that new employees or current employees who fail to make a timely cafeteria plan election may be enrolled in a default election for one or more qualified benefits. For example, a cafeteria plan could provide that an election made for any prior year is deemed to be continued for every succeeding plan year, unless changed.

Unfortunately, the new proposed regulations are silent with respect to whether a plan administrator may allow an election to be made, changed, or revoked after an applicable deadline upon a showing of clear and convincing evidence of a mistake. The "mistake" exception is a long-standing informal IRS position and its absence from these regulations suggests that the IRS may no longer recognize this exception.

✓ ***Action Item*: *Review election procedures to determine whether new hires are required to make elections within 30 days of hire date. Also, verify that the cafeteria plan allows employees to change salary reduction contributions to the HSA prospectively at any time. If elections are made electronically or automatically, verify that such elections are made in accordance with applicable guidance. Consider providing comments to the IRS requesting additional flexibility from the IRS if any of these requirements are administratively burdensome, or if there is a need for exceptions (e.g., an exception that would allow a plan administrator to accept a late election from an employee due to extenuating circumstances or to change an election upon demonstrating clear and convincing evidence of a mistake).***

XI. Flexible Spending Accounts ("FSAs")

A. Generally

The proposed Flexible Spending Account ("FSA") rules largely restate the previous proposed regulations applicable to FSAs. An FSA allows employees to seek reimbursement on a tax-favored basis for specific permitted expenses that are incurred during the plan year or grace period, if applicable. All expenses must be substantiated before the expenses are reimbursed. Qualified benefits that may be offered through an FSA include: medical reimbursement, dependent care assistance and adoption assistance. This is the first IRS guidance that has characterized adoption assistance as an FSA.

As part of a cafeteria plan, FSAs must include an election between cash or taxable benefits (e.g. salary reductions). The new proposed regulations provide that "employer flex-credits" are also permitted under an FSA. Flex credits are non-elective employer contributions made to all employees eligible under the cafeteria plan that can be exchanged for qualified benefits.

Consistent with informal IRS statements, the new proposed regulations provide that the cafeteria plan is permitted to specify any interval for employees' salary reduction contributions as long as the interval specified in the plan is uniform for all participants. So, for example, salary reduction contributions for an FSA, which are generally collected monthly, could be collected more frequently or less frequently (e.g., on a bi-weekly or quarterly basis). The IRS has also indicated informally in the past that an employer could collect salary reduction contributions from a terminated employee's "last paycheck." However, the new proposed regulations do not describe this ability. To the contrary, the new proposed regulations contain a new rule which provides that an employer has an obligation to reimburse an employee for any salary reduction contributions attributable to periods of coverage after termination of employment.

✓ ***Action Item*: *Review adoption assistance program to assure that treatment of adoption assistance benefits conforms to FSA rules. Consider whether to alter the timing of salary reduction contributions. Consider providing comments requesting that the IRS specifically allow the collection of salary reduction contributions from a terminated employee's last paycheck, if permitted under state law, and to eliminate the***

requirement that an employer needs to reimburse a participant for salary reduction amounts collected prior to the date of termination.

B. <u>Plan Year/Use-or-Lose</u>

During a regular plan year, the new proposed regulations, consistent with the previous proposed regulations, provide that the period of coverage for an FSA must be twelve months, but a short plan year is permitted if there is a valid business purpose. The new proposed regulations clarify that each benefit available through an FSA may have a separate period of coverage distinct from the cafeteria plan year. Such periods of coverage may not be structured in a manner that would allow a participant to elect coverage for a health FSA only for those periods in which medical expenses are expected to be incurred.

All elections under an FSA are subject to the "Use-or-Lose" rule that prohibits FSA contributions from being carried over into future plan years. Consistent with prior guidance and as discussed in Section I.C. of this memorandum, the IRS retained a limited exception to this rule, which permits an employer to adopt a "grace period" of up to 2-1/2 months during which an employee may continue to incur expenses after the end of the plan year. Employers can also elect a "run-out period" during which expenses incurred during the plan year and grace period may be reimbursed.

✓ ***Action Item: Review FSA plan documents to verify that coverage period for all FSAs is described as 12 months. Confirm that health FSA benefits, dependent care assistance benefits and adoption assistance benefits are all subject to a use-or-lose rule. Consider whether to adopt a grace period or run-out period for the FSAs.***

C. <u>Health FSAs</u>

Health FSAs are subject to the "uniform coverage" rule, which requires the maximum amount of elected reimbursement to be available to the employee at all times during the calendar year without regard to the employee's year-to-date contributions.[5] For example, if an employee elects to allocate $1,200 to a health FSA for the calendar year, in January, the employer must credit the FSA with the full amount of the annual election even though the employer would generally only reduce the employee's salary by $100 in January. So, if the employee incurs a qualified medical expense of $1,200 in January, the employer would be required to reimburse the entire $1,200 expense. As described in Section I.A. of this memorandum, the uniform coverage rule must be described in the cafeteria plan document if the cafeteria plan offers a health FSA. The new proposed regulations require that an employee must be able to request reimbursement at least monthly or when the total amount of the claim equals a specified amount (the regulations suggest fifty dollars.)

Formalizing long standing informal guidance, and as described in Section VIII of this memorandum, the regulations also confirm that health FSAs may reimburse advance payments

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[5] The IRS has requested comments on the new proposed regulations concerning how the participant's uniform coverage amount should be computed after a change in election.

for orthodontia services without violating the no-deferred-compensation rule, where the employee is required to make the advance payments in order to receive the services. This rule also applies to medical equipment with a useful life extending beyond the plan year. The use of these two specific examples raises questions as to how this guidance will apply to other benefits paid in a similar manner. Previously, the IRS has informally suggested that advance payments for pre-natal benefits could also be reimbursed from a health FSA. However, the IRS did not include a description of this ability in the proposed regulations.

The proposed regulations permit a cafeteria plan to limit health FSA enrollment to employees who also participate in one or more of the employer's accident and health plans.

✓ ***Action Item*: *Review health FSA document for conformance with the uniform coverage rule. Consider providing comments requesting clarity from the IRS regarding the no-deferred-compensation rule and its application to pre-paid expenses such as pre-natal care or similar services where advance payment is required. Consider whether to limit participation in a health FSA to employees who also participate in the employer's accident and health plans.***

D. <u>Health FSA with HSA</u>

The new proposed regulations also retain the rules permitting a "limited purpose" health FSA (reimbursing only those benefits that are permitted with an HSA such as vision or dental only), a "post deductible" health FSA (reimbursing qualified expenses only after the minimum deductible under an HSA compatible high deductible health plan has been incurred). The regulations also contain a new rule which provides that a health FSA could also be structured as a combination limited-purpose/post-deductible health FSA without impacting HSA eligibility. So, for example, a health FSA could function as a limited purpose arrangement until the minimum deductible under Code section 223 is satisfied, and then the FSA could convert to a general purpose FSA.

The proposed rules clarify that an employer must amend its cafeteria plan prior to the beginning of the plan year in order to allow employees to elect to make a one-time rollover from a health FSA to an HSA. The rules note that such distributions will not alter an employee's election or constitute a change in status. These regulations implement the changes made in the Tax Relief and Health Care Act of 2006, and adopt the administratively cumbersome requirements for tax-free rollovers described in Notice 2007-22.

✓ ***Action Item*: *Review current FSA/ HSA structure and consider implementing a limited-purpose, post-deductible or combination FSA where HSA coverage is also available. In order to allow a tax-free rollover from an FSA to an HSA, confirm that the requirements described in these new proposed regulations and the requirements described in Notice 2007-22 are satisfied.***

E. Dependent Care Assistance Program ("DCAP") Spend-Down

The new proposed cafeteria plan regulations incorporate informal IRS statements permitting a DCAP, which reimburses expenses for dependent care while a participant is working or looking for work, to include a spend down period after a participant terminates participation in the cafeteria plan due to termination of employment. During the spend-down period, a participant may continue to draw down elected amounts for eligible expenses. This rule does not apply to health FSAs.

✓ ***Action Item: Consider amending cafeteria plan to include DCAP spend-down option.***

F. FSA Experience Gains

The new proposed regulations clarify that FSA experience gains (i.e. end of plan year forfeitures) may be: (1) retained by the employer maintaining the cafeteria plan, (2) used to reduce salary reductions for the following plan year, (3) returned to employees on a uniform basis or (4) used to defray expenses to administer the cafeteria plan. We note that an employer's retention of experience gains may raise issues under ERISA in some circumstances. Consistent with previous proposed regulations, the rules emphasize that allocation of experience gains may never be based on employees' individual claims experiences.

✓ ***Action Item*: *Review the manner in which experience gains are used by the plan, considering both the new proposed regulations and ERISA.***

XII. SUBSTANTIATION

The proposed regulations clarify the rules for the substantiation of expenses under a cafeteria plan. A cafeteria plan may only pay or reimburse substantiated expenses for qualified benefits incurred on or after the effective date of the plan and the employee's enrollment, and during the period of coverage. The new rules emphasize that all reimbursements must be individually substantiated, and must be substantiated by a third-party independent of the employee. No reimbursement may be made before expenses are incurred.

✓ ***Action Item*: *Confirm that current administrative procedures conform to individual substantiation requirement.***

A. Health FSA

The new proposed regulations contain new substantiation rules pertaining to post-deductible and limited-purpose health FSAs. Participants in post-deductible health FSAs must provide independent third-party substantiation that the HDHP deductible has been satisfied, and participants in limited-purpose health FSAs must provide independent third-party substantiation that the expenses are for permissible expenses.

✓ ***Action Item*: *Review substantiation procedures and update if necessary. Consider commenting on any administrative difficulties raised by new substantiation requirements for post-deductible and limited purpose health FSAs.***

B. DCAPS

The new proposed regulations emphasize that DCAP expenses may not be reimbursed before the expenses are incurred. Dependent care is considered to be incurred at the time the care is provided. This rule raises problems for many DCAP participants. For example, many daycare providers charge participants on the first of the month for the entire month's care. These expenses would not be reimbursable until the end of the month, despite the fact the participant paid on the first. This requires participants to set aside an entire month of daycare costs on an after-tax basis in order to pre-fund daycare cost, which will not be reimbursed on a pre-tax basis until the end of the month. In addition, the rule is administratively complex for employers to administer because all daycare providers do not adhere to the same billing schedule.

✓ ***Action Item*: *Review DCAP substantiation/reimbursement procedures to verify that no reimbursement occurs until after the care is provided. If this is not the case, consider providing comments requesting that the IRS allow additional flexibility concerning timing of DCAP reimbursements due to the administrative burdens associated with compliance.***

C. Debit or Stored Value Cards

The new proposed regulations include new requirements and incorporate prior guidance for expenses reimbursed through a debit, credit or stored value cards ("debit card") See Rev. Rul. 2003-43, Notice 2006-69, and Notice 2007-2. This guidance, which is incorporated wholesale into the new proposed regulations, regulates where a debit card can be used, what controls must be in place, when debit card charges must be substantiated with additional documentation, and what correction procedures the employer must use when substantiation is not provided. The IRS debit card rules are complicated and administratively burdensome, and if the rules are incorporated into final IRS regulations, it will be difficult for the IRS to simplify or change the rules in the future in response to evolving technology.

One controversial requirement that has been incorporated into the new proposed regulations is that the employer must limit the use of the debit card to certain medical providers with a medical merchant category code ("MCC") (e.g. physicians' offices, dental offices, etc.), or, effective for plan years after December, 31, 2008, to stores that have a Drug Store and Pharmacy MCC if 90% of the store's gross receipts during the prior taxable year consisted of items which qualify as medical care under Code section 213(d). This requirement presents difficulties for many businesses that sell over-the-counter medicine and drugs but do not satisfy these requirements. IRS guidance, and now the new proposed regulations, indicates that any store that does not meet these requirements may only allow use of the debit card if the store has implemented an "inventory information approval system." Inventory information approval systems are described in Notice 2006-69, and permit businesses that do not have a medical MCC or a Drug Store and Pharmacy MCC (satisfying the 90% test) to participate in the debit card real-

time substantiation by using stock keeping units (SKUs) or other inventory control information that is compared against a list of allowable Code section 213(d) expenses in order to substantiate a claim at the site of purchase.[6]

The use of an inventory information approval system not only allows a debit card to be used to purchase over-the-counter drugs at any store regardless of MCC designation, but also allows debit card charges to be considered "automatically substantiated" without further documentation. However, under the new proposed regulations, the IRS clarifies that employers are responsible for assuring that any inventory information approval system used in connection with an FSA debit card complies with applicable substantiation, reimbursement, and recordkeeping requirements.

Previous IRS guidance, and now the new proposed regulations, describe additional categories of debit card charges that are considered automatically substantiated (e.g., matching co-payments in multiples of five or fewer, re-occurring expenses that match previously substantiated amount and expenses that are substantiated at the time and point of sale, for example by a pharmacy benefit manager). All other payments reimbursed through a debit card are treated as "conditional" pending substantiation. The proposed rules also provide a correction procedure for debit card charges that are not substantiated, including de-activation of the debit card and specific steps that an employer must follow to recover improper payments.

✓ ***Action Item*: *Consider commenting to the IRS that incorporation of these debit card rules to final regulations will impede the ability to change these rules as technology evolves. Accordingly, the debit card guidance should be eliminated or made more general in these proposed regulations.***

XIII. Nondiscrimination Rules

If a cafeteria plan discriminates in favor of highly compensated individuals, the highly compensated participants must include in income an amount equal to the highest value of benefits he or she could have elected to receive under the discriminatory cafeteria plan. Similarly, if key employees elect more than 25% of the aggregate benefits elected by all employees under a cafeteria plan, key employees must include amounts that could have been elected in income. The new proposed regulations provide more detail than the previous proposed regulations concerning how to determine whether a cafeteria plan complies with these nondiscrimination rules. However, more specific guidance and examples are critical in order to fully understand these requirements, particularly because employers that contribute to HSAs through the cafeteria plan are required to comply with these nondiscrimination rules rather than the comparable contribution rules under Code section 4980G. Because of the uncertainty concerning how to apply these rules, many employers may not have rigorously tested their cafeteria plans to ensure compliance in the past. Once these proposed regulations become final,

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[6] All supermarkets, grocery stores, discount stores, and wholesale clubs that do not have an MCC related to health care will be deemed to be a medical care provider with respect to debit card transactions occurring on or before December 31, 2007. Notice 2007-2.

there will likely be a greater emphasis at the IRS on determining whether these rules have been followed by employers.

A. Highly Compensated Individuals

For purposes of applying the nondiscrimination rules for cafeteria plans, highly compensated individuals are those who in the current year are (i) an officer, (ii) a more than five percent shareholder in the employer or (iii) a highly compensated employee. While similar to the rules used for determining who is a highly compensated employee under the tax-qualified plan nondiscrimination rules, the definitions under the cafeteria plan rules are not the same. This will require employers to separately track who constitutes a highly compensated employee for different nondiscrimination testing purposes.

An employee is an "officer" for purposes of these nondiscrimination tests based on the duties and responsibilities of the individual, requiring an analysis of what an individual's job position entails. There is no minimum compensation requirement for being considered an officer or no overall limit on how many employees can be counted as officers.

An employee is a "highly compensated employee" for purposes of these nondiscrimination tests if the employee's compensation is over $100,000 (for 2007) in the preceding plan year (or the current year in the case of the first year of employment). In contrast, the qualified plan rules do not include someone as highly compensated in their first year of employment. The alternate rule in qualified plan nondiscrimination testing for determining whether someone is highly compensated – limiting the group to the top 20 percent of employees in terms of compensation during the year – may also be used to determine who is highly compensated under the cafeteria plan nondiscrimination testing rules.

✓ ***Action Item: Review current practices for determining which employees are "highly compensated individuals." Consider commenting to the IRS that, to the extent possible, the definition of highly compensated individual for purposes of these rules should be the same as the definition that applies for purposes of the qualified retirement plan rules.***

B. Nondiscrimination in Eligibility

A cafeteria plan cannot discriminate in favor of highly compensated employees with regard to eligibility to participate in the cafeteria plan or with respect to the contributions and benefits provided in a cafeteria plan. The new proposed regulations provide some detail as to how the various nondiscrimination tests are to be applied but the requirements are still not entirely clear.

The nondiscrimination rules regarding eligibility to participate follow the reasonable classification test provided for in the tax-qualified plan nondiscrimination rules. This rule consists of a two-part test. First, an employer can only limit eligibility to certain "reasonable classifications" of employees, such as those based on job categories, salaried or hourly job categories, geographic location and other bona fide business classifications. Second, the percentage of non-highly compensated employees who are able to participate in the cafeteria

plan as a percentage of the entire employee population must meet or exceed various safe harbor percentages. In making this determination, employers who do not allow employees to participate in the cafeteria plan until they have completed 3 years of employment can disregard such employees in determining whether eligibility for the plan discriminates in favor of highly compensated employees. Also excluded from this determination are employees covered by a collective bargaining agreement (except key employees), nonresident aliens with no earned income in the US from the employer and those employees who are participating in the cafeteria plan due to COBRA. Of course, a cafeteria plan that allows every employee to participate will not be considered discriminatory with respect to eligibility.

✓ ***Action Item*: *Consider submitting comments to the IRS requesting that examples be included in the final regulations to illustrate how the reasonable classification test should be applied in the cafeteria plan context.***

C. Nondiscrimination in Contributions and Benefits

A cafeteria plan also must not discriminate with regard to benefit availability and the benefits elected. The new proposed regulations provide that each similarly situated employee must have the same opportunity to elect qualified cafeteria plan benefits and those benefits must not be disproportionately elected by highly compensated participants.

In this regard, the new proposed regulations state that the dollar amount of benefits elected by all highly compensated participants in the plan divided by the aggregate compensation of those employees (expressed as a percentage) cannot exceed the dollar amount of benefits elected by all non-highly compensated participants divided by the aggregate compensation of those employees (also expressed as a percentage). Regarding contributions to the cafeteria plan, similarly situated participants must also be given the same opportunity to elect employer contributions under the cafeteria plan. In addition, highly compensated participants cannot disproportionately utilize the cafeteria plan contributions for qualified benefits; whether this has occurred is determined in manner similar to that used to determine whether benefit election disproportionately benefited highly compensated participants.

✓ ***Action Item*: *Consider submitting comments to the IRS requesting that examples be included in the final regulations to illustrate how the contribution and benefits test should be applied in the cafeteria plan context be included in the final regulations, including with respect to contributions to an HSA.***

D. Key Employee Concentration Test

A cafeteria plan is also considered to be discriminatory if more than 25 percent of the aggregate benefits provided under a cafeteria plan go to key employees. Generally this will not affect cafeteria plans of larger employers, since the number of key employees is limited to 50 employees and shareholders of 5% or more and 1% shareholders who have compensation is in excess of $145,000. However, it is not clear how to measure benefits for purposes of this test, particularly with respect to HSAs.

✓ ***Action Item*: *Consider submitting comments to the IRS requesting that examples be included in the final regulations to illustrate how the key employee test should be applied in the cafeteria plan context, including with respect to contributions to an HSA.***

E. <u>Safe Harbors</u>

The new proposed regulations provide two safe harbors from the non-discrimination rules. One safe harbor, which is provided in the statute itself, states that contributions on behalf of each participant are at least equal to (i) 100 percent of the cost of the health plan coverage of the plan that benefits the majority of highly compensated participants; or (ii) 75 percent of the cost of the highest cost health benefit in the plan, and any contributions in excess of the 100 percent or 75 percent amount must bear a uniform relationship to compensation. It is not clear how to apply this safe harbor, and the new proposed regulations do not provide any clarification or helpful examples. The second safe harbor, which is new, provides that premium only plans are also considered a safe harbor design if they pass the nondiscrimination test regarding eligibility.

✓ ***Action Item*: *Consider submitting comments to the IRS requesting that examples be included in the final regulations to how the safe harbors should be applied, including with respect to contributions to an HSA.***

F. <u>Other Rules</u>

The new proposed regulations state that the actual operation of the plan must not discriminate in favor of highly compensated participants in operation. However, there are no helpful illustrations of how this requirement would apply. In addition, the new proposed regulations provide rules for aggregating and disaggregating cafeteria plans for purposes of determining whether the plan is discriminatory, but again, contain no illustrations of these rules.

The new proposed regulations provide that the nondiscrimination tests must be conducted annually as of the last day of the plan year and must include any non-excludible employees who were employees at any time during the year. There is much less flexibility in the timing and manner of the nondiscrimination testing of cafeteria plans than is permitted for qualified plans.

✓ ***Action Items: Consider commenting to the IRS that, to the extent possible, the timing and manner of nondiscrimination testing for purposes of these rules should be the same as the timing and manner of nondiscrimination testing that applies for purposes of the qualified retirement plan rules.***

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Please contact Christine Keller, Bill Sweetnam, Heather Meade, or Sarah Touzalin if we may answer any additional questions or for assistance with preparing comments regarding the new proposed regulations.

End-of-Year Plan Amendment and PPA Cash Balance Issues

October 2007

With the end of the 2007 calendar year approaching, it is again time for many plan sponsors to evaluate whether they need to adopt any "interim" amendments to their plans.[1] Optional plan amendments (called "discretionary" amendments), such as Roth 401(k) contributions, must be adopted by the close of the plan year to which they apply. Required plan amendments (called "interim" amendments), such as the mandatory portions of the final 401(k) regulations, have a later required adoption date that is generally based on the due date, including extensions, for a sponsoring employer's tax return.[2] Lastly, certain other plan amendments, such as those related to the hurricane relief laws, must be adopted by the end of plan years beginning in 2007.

This end-of-year is especially complex. Effective in 2008, many of the Pension Protection Act's ("PPA") cash balance provisions become applicable to cash balance plans in existence on or before June 29, 2005. Special operational effective date rules apply to collectively bargained plans that can, in, certain cases, delay the effective date until as late as plan years beginning before January 1, 2010. In addition, while a number of plan changes under consideration by plan sponsors are related to the PPA and are therefore eligible for the Pension Protection Act's special effective date rules,[3] certain changes to the IRS rules, such as the 415 maximum benefit/contribution rules, are not PPA related and are subject to the IRS interim amendment rules.

This chart is structured in four parts:

- Pension Protection Act Issues for Cash Balance Plans;
- Pension Protection Act Issues for All Defined Benefit Plans;
- Potential Defined Benefit Plan End-of-Year Amendments; and
- Potential Defined Contribution Plan End-of-Year Amendments.

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[1] Interim amendments are required under the IRS determination letter program procedures set forth in Revenue Procedure 2007-44. Under Revenue Procedure 2007-44 and its predecessor, the IRS publishes a "cumulative list" of required changes for tax-qualified plans. The most recent cumulative list, the 2006 Cumulative List of Changes in Plan Qualification Requirements, was published in Notice 2007-3.

[2] More detailed required amendment timing rules are set forth in Revenue Procedure 2007-44.

[3] Generally by the close of the first plan year beginning on or after January 1, 2009, although operational compliance is required once a PPA provision is put into effect. Special amendment timing rules apply to governmental plans.

PENSION PROTECTION ACT ISSUES FOR CASH BALANCE PLANS

Topic	Provision Optional or Required	Effective Date	Description of Amendment
Age Discrimination	Required	June 29, 2005	If determined that current plan language is not sufficient, plan should be revised to track new rules clarifying that, under the terms of the plan, a participant's "accrued benefit" is equal to or greater than a similarly situated younger person, to ensure that the plan will not violate the age discrimination provisions under ERISA, the Code, and ADEA. Based on recent experiences with IRS cash balance plan determination letter reviewers, it is not clear that the expression, for all purposes, of a participant's "accrued benefit" as a lump sum or a percentage of a participant's final average compensation, will be acceptable to the IRS.
Interest Credit	Required	For plans in existence on June 29, 2005, applies to years beginning after December 31, 2007, but may be applied as early as June 29, 2005. For new plans established after June 29, 2005, effective upon establishment of plan. Special collectively bargained plan effective date rules apply.	Plan should be amended to provide an interest credit no greater than a market rate. This requirement does not preclude the use of a reasonable minimum guaranteed rate or a rate that is equal to the greater of a fixed or variable rate. The interest crediting rate cannot cause the account balance to be less than the aggregate principal contributions made to the account. Special rules apply for plan terminations. For example, if the interest credit rate is a variable rate, the plan must provide that, upon plan termination, the rate used to determine accrued benefits under the plan shall be equal to the average of the interest rates used under the plan during the past 5 years.

Topic	Provision Optional or Required	Effective Date	Description of Amendment
Whipsaw Calculations	Optional	Distributions after August 17, 2006	Plan may be amended to eliminate any "whipsaw" calculations for determining the present value of a participant's accrued benefit.
Vesting	Required	For plans in existence on June 29, 2005, applies to years beginning after December 31, 2007, but may be applied as early as June 29, 2005. For new plans established after June 29, 2005, effective upon establishment of plan. Special collectively bargained plan effective date rules apply.	If current vesting period is longer, plan must be amended to fully vest participants after 3 years of service. Pending technical corrections would clarify that this rule applies only to participants with an hour of service on or after the effective date of this provision.
Valuation of Lump Sum Distributions	Required as a Minimum	Plan Years beginning after December 31, 2007	New interest rate for determining the minimum value of lump sum distributions, Social Security leveling and other non-life annuity options. Treasury to provide an applicable mortality table. A plan amendment may be necessary to maintain the current interest rate and mortality table (if so desired), but new rates will still apply to determine minimum value. This approach may raise QJSA valuation issues and cutback concerns if the rate is later changed to the PPA rate. Otherwise, this provision is subject to the special PPA amendment timing rules.

Topic	Provision Optional or Required	Effective Date	Description of Amendment
Valuation of Lump Sum Distribution for Section 415(b) Limits	Required	Distributions for years beginning after December 31, 2005 (subject to transition rules)	Plan must provide that the interest rate used to convert a straight life annuity to a lump sum amount rate must not be less than the greater of (i) 5.5 percent, (ii) the plan's interest rate, or (iii) a rate that produces a benefit of not more than 105 percent of the benefit calculated using the minimum value lump sum interest rate.

PENSION PROTECTION ACT ISSUES FOR ALL DEFINED BENEFIT PLANS[4]

Topic	Provision Optional or Required	Effective Date	Description of Amendment
Joint and Survivor Distributions	Required	Plan Years beginning after December 31, 2007 Special collectively bargained plan effective date rules apply.	Plan must be amended to add a new "qualified optional survivor annuity" ("QOSA"). If a plan's existing qualified joint and survivor annuity provides a survivor benefit that is less than 75 percent of the annuity payable during the joint lives of the participant and spouse (e.g., the survivor annuity is 50 percent), the applicable survivor percentage for the QOSA is 75. If, however, the plan's existing survivor annuity benefit is 75 percent or greater, the applicable percentage for the QOSA is 50.
In-Service Distributions	Optional	Distributions in Plan Years beginning after December 31, 2006	Plan may be amended to provide in-service distributions to a participant who (i) attains age 62 and (ii) continues in employment, even if the plan's normal retirement is age 65.
Highest 3 Years of Compensation For Section 415 Limit	Required	Years beginning after December 31, 2005	If plan does not already so provide, plan should clarify that compensation earned during a participant's highest 3 years shall not be limited to only those years when the participant was an active participant in the plan, but rather, shall include all years when the participant was employed by the plan sponsor.
Rollover of After-Tax Amounts	Optional/ Required	January 1, 2007	Plans **may** be amended to accept after-tax rollover amounts. Plans **must** permit participants to directly roll over any after-tax contributions from the plan to DB, DC, or 403(b) plans.

[4] This chart does not address the new Internal Revenue Code funding rules or issues specific to governmental plans.

Topic	Provision Optional or Required	Effective Date	Description of Amendment
Rollovers by Non-spouse Beneficiaries	Optional	January 1, 2007	Plan may be amended to permit nonspouse beneficiaries to transfer amounts from plan directly to an IRA. The IRA is treated as an inherited IRA for purposes of the minimum required distribution rules. Proposed legislation would make this rule mandatory.
Direct Rollovers to Roth IRAs	Optional (subject to guidance)	January 1, 2008	Plan may be amended to permit direct rollovers from plan to a Roth IRA.
Notice and Consent Period Regarding Distributions and QJSA Waiver	Optional	Plan Years beginning after December 31, 2006	The plan may be amended to extend the special tax notice and QJSA waiver notice period (and distribution consent, if set forth in a plan) from 90 days to 180 days.

POTENTIAL END-OF-2007 AMENDMENTS FOR DEFINED BENEFIT PLANS

Topic	Provision Optional or Required	Effective Date	Description of Amendment and Special Adoption Timelines (If Any)
Permissible Normal Retirement Age	Required	May 22, 2007 Special collectively bargained and governmental plan effective date rules apply. IRS transition guidance delays the effective date for certain plans with a normal retirement age prior to age 62 until the end of the first Plan Year beginning after June 30, 2008 for plans that comply with the transition rules	Plan's normal retirement age must be no earlier than the age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. Normal retirement ages are evaluated as follows: • Normal retirement ages of age 62 or later are deemed to satisfy this rule. • Normal retirement ages between age 55 and 62 must be reasonably representative of typical retirement age based on a facts-and-circumstances analysis. • Normal retirement ages less than age 55 are presumed to not satisfy these rules, unless IRS determines otherwise. • If qualified public safety employees are substantially all of the participants in a plan, a normal retirement age of 50 or later shall be deemed reasonably representative of typical retirement age. A normal retirement age based solely on service will, in most cases, not qualify as an acceptable normal retirement age. The IRS is still evaluating the application of this rule to governmental plans. Regular "interim" amendment adoption timelines apply.

Topic	Provision Optional or Required	Effective Date	Description of Amendment and Special Adoption Timelines (If Any)
Hurricane Relief Provisions	Optional	2005	KETRA and GOZA allowed for hurricane-related distributions, recontributions of withdrawals for home purchases, and added special loan rules. Amendments must be adopted by the last day of the plan year beginning on or after January 1, 2007. Special rules apply to governmental plans.
Final Section 415 Regulations	Required	Limitation Years beginning on or after July 1, 2007 Special governmental plan effective date rules apply.	Comprehensive revision of Section 415 maximum benefit limitations will apply to calendar year limitation year plans effective January 1, 2008. These rules also include the final rules governing the inclusion of post-severance pay that impact a number of plan sponsors. Certain provisions of the final Section 415 regulations, but not all, are eligible for the delayed PPA and/or Pension Funding Equity Act amendment timing rules. Otherwise, regular "interim" amendment adoption timelines apply. However, due to cutback concerns, plan sponsors should review the 415 regulations prior to year-end to ensure no plan amendment is needed by year-end (e.g., definition of compensation).
Valuation of Lump Sum Distributions	Required as a Minimum	Plan Years beginning after December 31, 2007	New interest rate for determining the minimum value of lump sum distributions, Social Security leveling and other non-life annuity forms. Treasury to provide an applicable mortality table. A plan amendment may be necessary to maintain the current interest rate and mortality table (if so desired), but new rates will still apply to determine minimum value. This approach may raise QJSA valuation issues and cutback concerns if the rate is later changed to the PPA rate. Otherwise, this provision is subject to the special PPA amendment timing rules.

Topic	Provision Optional or Required	Effective Date	Description of Amendment and Special Adoption Timelines (If Any)
Anti-Cutback Regulations Relating to Central Laborers' Pension Fund v. Heinz.	Required	Plan amendments adopted after August 9, 2006	Final anti-cutback regulations expand Heinz analysis to plan amendments that place greater restrictions on protected benefits with respect to vesting (potentially even if the amendment adds a restriction permitted under the vesting rules), not just suspension of benefits. Existing catch-all anti-cutback language may already address this requirement, but the IRS defined benefit listing of required modifications contains model language. If a plan's vesting provisions were amended in 2007, consider amending the plan to include this model language in accordance with the regular "interim" amendment timeline.

POTENTIAL END-OF-2007 AMENDMENTS FOR DEFINED CONTRIBUTION PLANS[5]

Topic	Provision Optional or Required	Effective Date	Description of Amendment and Special Adoption Timelines (If Any)
Permissible Normal Retirement Age	Required	May 22, 2007 Special collectively bargained and governmental plan effective date rules apply. IRS transition guidance delays the effective date for certain plans with a normal retirement age prior to age 62 until Plan Years beginning after June 30, 2008 for plans that comply with the transition rules	Money purchase plan's normal retirement age must be no earlier than the age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. Normal retirement ages are evaluated as follows: • Normal retirement ages of age 62 or later are deemed to satisfy this rule. • Normal retirement ages between age 55 and 62 must be reasonably representative of typical retirement age based on a facts-and-circumstances analysis. • Normal retirement ages less than age 55 are presumed to not satisfy these rules, unless IRS determines otherwise. • If qualified public safety employees are substantially all of the participants in a plan, a normal retirement age of 50 or later shall be deemed reasonably representative of typical retirement age. A normal retirement age based solely on service will, in most cases, not qualify as an acceptable normal retirement age. The IRS is still evaluating the application of this rule to governmental plans. Regular "interim" amendment adoption timelines apply.

[5] Please note this does not include provisions related to the Pension Protection Act (e.g., non-spouse rollovers) since such amendments may be deferred pursuant to section 1107 of the Act.

Topic	Provision Optional or Required	Effective Date	Description of Amendment and Special Adoption Timelines (If Any)
Hurricane Relief Provisions	Optional	2005	KETRA and GOZA allowed for hurricane-related distributions, recontributions of withdrawals for home purchases, and added special loan rules. Amendments must be adopted by the last day of the plan year beginning on or after January 1, 2007. Special rules apply to governmental plans.
Final Section 415 Regulations	Required	Limitation Years beginning on or after July 1, 2007 Special governmental plan effective date rules apply.	Comprehensive revision of Section 415 maximum contribution limitations will apply to calendar year limitation year plans effective January 1, 2008. These rules also include the final rules governing the inclusion of post-severance pay that impact a number of plan sponsors. Certain provisions of the final Section 415 regulations, but not all, are eligible for the delayed PPA amendment timing rules. Otherwise, regular "interim" amendment adoption timelines apply. However, due to cutback concerns, plan sponsors should review the 415 regulations prior to year-end to ensure no plan amendment is needed by year-end (e.g., definition of compensation).
Roth Contributions	Optional	Tax Years beginning after December 31, 2005	After-tax Roth contributions may be added to a 401(k) plan. Regular "discretionary" amendment adoption timelines apply.
S-Corporation ESOP Stock Allocation to Disqualified Persons	Optional	Plan Years beginning on or after January 1, 2006	Final regulations governing prohibited allocation of S-corporation securities to disqualified persons retain the triennial method of determining synthetic equity but do allow a modification in certain circumstances. This optional change to the triennial method requires that a plan amendment be adopted before a new determination date.

Topic	Provision Optional or Required	Effective Date	Description of Amendment and Special Adoption Timelines (If Any)
Anti-Cutback Regulations Relating to Central Laborers' Pension Fund v. Heinz.	Required	August 9, 2006	Final anti-cutback regulations expand Heinz analysis to plan amendments that place greater restrictions on protected benefits with respect to vesting (potentially even if the amendment adds a restriction permitted under the vesting rules), not just suspension of benefits. Existing catch-all anti-cutback language may already address this requirement, but the IRS defined benefit listing of required modifications contains model language. If a plan's vesting provisions were amended in 2007, consider amending the plan to include this model language in accordance with the regular "interim" amendment timeline.