Paul Hastings
StayCurrent
A CLIENT ALERT FROM PAUL HASTINGS
December 2008

# 401(k), Pension, and Welfare Plans: 2008 Year-End Compliance Matters

BY J. MARK POERIO, ERIC KELLER, JAMIE DVORETZKY AND ANDREA GEHMAN

With the year rapidly coming to an end, it is timely for retirement and welfare plan sponsors to consider updating their plans to reflect recent changes in applicable law. This alert provides information about four developments from 2008 that should now be on the radar screen for plan sponsors.

## (1) Code Section 415 – Some Required Plan Changes Before 2010

Tax-qualified retirement plans must comply with the final regulations under Internal Revenue Code Section 415. These regulations are effective for plan limitation years beginning on or after July 1, 2007 (January 1, 2008 for calendar-year plans). Generally, most plans will need to be amended to comply with the final regulations no later than the sponsoring employer's tax return due date (including extensions) for the year in which the final regulations became effective (i.e., for calendar year plans, September 15, 2009). However, individually designed plans that are "Cycle C" plans (i.e., whose sponsoring employer's EIN ends in a "3" or an "8") must be amended to comply with the final regulations no later than January 31, 2009.

Section 415 limits both the annual contributions that may be made to defined contribution plans and the pension benefits that may accrue under defined benefit plans. In each case, the limits correlate to a participant's annual "compensation." Under the new regulations, annual compensation generally does not include compensation paid after a participant's severance from employment unless it is regular compensation earned during employment and paid within 2 ½ months following severance from employment or the end of the limitation year in which the severance occurs, or it falls within one of the special categories that plan amendments may implement, such as:

- certain payments for accrued and unpaid leave, or from an unfunded nonqualified deferred compensation plan, that are made within 2 ½ months after a participant's severance from employment or the end of the limitation year in which the severance occurs;[1]
- payments to participants who are permanently and totally disabled; and
- payments to participants engaged in qualified military service.

The final regulations limit Section 415 compensation to the compensation limit under Code Section 401(a)(17) (currently $230,000 for 2008). In addition, the regulations prohibit deferral elections to a 401(k) plan using a definition of compensation that includes compensation paid after severance from

employment unless it qualifies as Section 415 compensation. For example, severance pay may not be deferred into a 401(k) plan because it does not qualify as Section 415 compensation.

### (2) Proposed Section 125 (Cafeteria Plan) Regulations

Last August, the Internal Revenue Service issued proposed regulations governing the operation of cafeteria plans under Internal Revenue Code Section 125. Enforcement of the cafeteria plan tax rules has been lax in the past, but the proposed regulations put employers on notice that failure to operate a plan in compliance with the tax rules may result in the entire plan being disqualified and result in immediate taxable income for all participating employees. This would subject employers to potential tax liability for failure to satisfy their income tax and FICA and Medicare withholding and remittance obligations. While the proposed regulations noted an effective date of January 1, 2009, the regulations have yet to be finalized. Based on recent comments by Treasury officials, we believe the final regulations will be issued no later than early 2009 and will have an effective date of January 1, 2010. While it is too early for most employers to completely revise their plan documents in anticipation of the final regulations, employers should be prepared to make the appropriate adjustments once the rules are finalized.

The regulations focus on written plan and operational failures that would cause the plan to be deemed "not a cafeteria plan and employees' elections between taxable and nontaxable benefits [to] result in gross income to employees." Examples of such failures include:

- A failure to establish a written plan or to maintain a plan document that satisfies the requirements detailed in Treas. Reg. § 1.125-1(c).
- Offering benefits other than permitted taxable benefits and qualified benefits (e.g., impermissible benefits include scholarships, educational assistance under a section 127 plan, or long-term care).
- Reimbursing expenses through a flexible spending account ("FSA") that are not expressly permitted in Treas. Reg. § 1.125-5(o).
- Allowing employees to revoke elections or make new elections, except as provided under Treas. Reg. §§ 1.125-4 or 1.125-2(a).

The proposed 125 regulations also provide new benefit design options, such as:

- Allowing participants to pay COBRA premiums on a pre-tax basis. For example, a health plan participant who loses coverage by working reduced hours or who is terminated and receives a severance package may pay for COBRA on a pre-tax basis.
- Allowing employees to pay individual health policy premiums, or to be reimbursed for such premiums, on a pre-tax basis.
- Allowing new hires to immediately participate in the employer's cafeteria plan as long as the deductions are made from compensation not yet earned. For example, an employee may receive an FSA reimbursement for an expense incurred on his or her date of hire, but the FSA can only be funded by deductions from compensation earned after the employee's election to participate.
- Allowing reimbursement of advance payment of orthodontia expenses although the service date may be in a subsequent year. For example, if an employee must pay for a two-year orthodontia treatment program in advance, then the employee may claim

reimbursement for the entire amount, not just the orthodontia services rendered during the plan year.

The proposed 125 regulations contain additional nondiscrimination rules that, if finalized, will likely require many employers to adjust their cafeteria plan designs to avoid prohibited discrimination. For example, cafeteria plans that impose differing waiting periods or pricing structures that discriminate in favor of highly compensated individuals will likely need to be restructured. In addition, many cafeteria plans will need to pass complicated annual nondiscrimination testing that requires both benefit availability *and utilization* not to discriminate in favor of highly compensated individuals. However, cafeteria plans can avoid compliance with this requirement for health benefits if the employer provides an employer subsidy of at least 75% of the cost of the coverage. Employers should work with their third-party administrators now to determine whether their plans will have trouble passing these new tests and create work-arounds for those plans that have testing problems.

### (3) Mental Health Parity – Requires Changes Before 2010

On October 3, 2008, the Paul Wellstone and Pete Domenici Mental Health Parity and Addiction Equity Act of 2008 (the "Act") was signed into law as part of the $750 billion federal financial bailout legislation. Starting in 2010, the Act imposes significant new requirements on group health plans that offer mental health and substance abuse benefits, and repeals the sunset provisions of the current mental health parity law.

Existing mental health parity law already prohibits group health plans from imposing lower annual and lifetime limits for mental health coverage than for other types of benefits. The Act expands the scope of this law to prohibit other types of financial and non-financial limitations on mental health coverage and substance abuse benefits. Some of the Act's key provisions include:

- ***Financial Limitations***. Deductibles, copayments, coinsurance, and out-of-pocket expenses for mental health and substance abuse benefits must not be higher than for other types of medical coverage. This is in addition to the current law's prohibition of lower annual and lifetime benefit limitations.

- ***Treatment Limitations***. The Act prohibits group health plans from imposing limits on the frequency of treatment, number of doctor visits, days of coverage, or other similar limitations on the scope or duration of treatment for mental health or substance abuse that are more restrictive than for other types of medical benefits.

- ***Plan Information***. The Act requires group health plans to provide, upon request, information to plan participants and providers regarding the criteria for determining whether mental health or substance abuse treatment is medically necessary, and the reasons for denial of coverage.

- ***Out-of-Network Providers***. The Act requires group health plans that cover treatment by out-of-network providers for medical benefits to provide similar coverage for mental health and substance abuse benefits.

- ***Cost Exemption***. If complying with the Act will increase the cost of medical, surgical, mental health and substance abuse benefits by one percent (two percent in the first plan year of compliance), the plan may obtain a compliance exemption for the following plan year. To secure an exemption, the plan sponsor must obtain the opinion of a qualified actuary regarding the cost

increase and must notify the appropriate government agency.

### (4) The HEART Act Requires Employers to Provide Enhanced Benefits to Military Employees – Requires Changes Before 2010; Optional for 2009

The Heroes Earnings Assistance and Relief Tax Act (the "HEART Act"), signed on June 17, 2008, provides military employees with additional rights under employer-sponsored pension and welfare plans. The HEART Act has an immediate impact on the benefits payable to or on behalf of employees who are performing qualified military service. While in general, plans must be updated on or before the last day of the first plan year beginning on or after January 1, 2010, some provisions (noted below) are effective January 1, 2009 and others must be retroactive to January 1, 2007. Some of the required changes include:

- Tax-qualified pension plans are required to provide survivors of plan participants who die or become disabled while performing military service any additional benefits that would have been provided for those who die or become disabled as active participants. *These provisions are effective for deaths and disabilities occurring after January 1, 2007*.

- Effective *January 1, 2009*, the HEART Act requires that (a) active-duty members of the military who receive differential wage payments from their employer are deemed to still be in service, and (b) those payments are compensation for plan purposes. This provision, which was optional under the 415 regulations, is *required* under the HEART Act.

- Eligible military participants may elect to receive in-service plan distributions. If a participant receives a distribution on this basis, the participant may not make an elective deferral or employee contribution during the 6-month period beginning on the date of the distribution.

The HEART Act not only requires certain plan changes, but makes other changes both possible and beneficial for employees who perform military service. Such optional changes include the following, which employers may implement for any plan year starting after June 17, 2008:

- Employers may allow certain qualified reservists who are called to active duty to elect to receive a refund of amounts credited to them under an FSA to prevent loss due to the "use-it-or-lose-it" rule.

- Employers may treat an individual who dies or becomes disabled (as defined under the plan) while performing military service as if the deceased returned to employment with the employer the day before his or her death or disability for benefit accrual purposes.

- Employers may allow qualified reservists to take early distributions that are exempt from the 10% penalty tax for premature withdrawals.

✧ ✧ ✧

*For further information, contact any of the following members of the Paul Hastings ERISA and Global Benefits practice group:*

**Los Angeles**

Stephen H. Harris
213-683-6217
stephenharris@paulhastings.com

Ethan Lipsig
213-683-6304
ethanlipsig@paulhastings.com

**Washington, D.C.**

Eric R. Keller
202-551-1770
erickeller@paulhastings.com

J. Mark Poerio
202-551-1780
markpoerio@paulhastings.com

[1] Note that there is no special rule allowing amounts paid to "specified employees" that are subject to the 6-month delay under Code Section 409A to be included.