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Welcome to e-News: From the Labor, Employment and Benefits Group of Robinson & Cole

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IRS Issues New Regulations on COBRA

On January 10, 2001, the Internal Revenue Service issued new regulations clarifying a number of provisions of COBRA and making several changes to the regulations originally proposed in 1999. The regulations clarify that a small employer is any employer that had fewer than 20 employees on a typical business day in the prior calendar year. Small employers are exempt from the requirements of federal COBRA, although they may be subject to state COBRA laws. Unlike in the proposed regulations, the final regulations provide that all health care plans are treated as one plan, unless it is clear from the instruments that the benefits are being provided through or operated as separate plans. The proposed regulations had reversed the order of these priorities.

The regulations also clarify that with respect to beneficiaries who move out of the service area of a region specific benefit package, alternative coverage must be made available no later than the relocation date or the first day of the month after the request for alternative coverage is made. The regulations specifically allow health care plans to terminate coverage

and retroactively reinstate, once a beneficiary has made COBRA payments. Also, the regulations clarify that if payments are deficient by the lesser of $50.00 or 10% of the required payment, that amount is not significant and the plan is required to treat that as a full payment, unless the beneficiary is notified and is given a reasonable period of time for the payment of the difference.

Finally, the regulations adopt almost all of the provisions regarding business reorganizations that were set forth in the proposed regulations.

IRS Issues Final Regulations Explaining Rules for Transportation Fringe Benefits

On January 11, 2001, the Internal Revenue Service issued final regulations regarding the exclusion of qualified transportation fringes in determining income for withholding, FICA and FUTA purposes. Under these rules, an employee can exclude up to $65.00 per month from gross income for transportation in commuter highway vehicles and for transit passes and up to $180.00 a month for parking. These amounts may be paid by an employer or paid through a salary reduction basis by an employee.

The final regulations, like the proposed regulations, are very flexible in allowing participants to make changes in elections under this program. In particular, election changes may be made on a monthly basis so long as a participant is not reimbursed for expenses already incurred and the election is only made for monies not yet earned. If money is withheld from a participant's check for these benefits and those expenses are not incurred, the amount may be carried over indefinitely or, if never used, would have to be forfeited. Excess withholdings cannot be returned to participants.

The final regulations also clarify the rules regarding the use of a voucher system with respect to the reimbursement of transit passes. In particular, cash reimbursement is allowed only if a voucher or a similar item, which may be exchanged only for a transit pass, is not readily available for direct distribution by the employer to the employee. If vouchers are readily available, the employer must use those vouchers and cash reimbursement would not be permitted.

Cafeteria Plan Election Changes Clarified and Expanded

The IRS has finalized regulations that clarify and expand the circumstances under which an employee is eligible to change an election of benefits under a cafeteria plan. Employees can now change cafeteria plan elections for group-term life insurance and disability benefits for all change in status events. Under prior rules, such an election change could only be made in the case of the change in employment status or marital status.

The regulations expand on the rules permitting election changes due to changes in the cost of coverage and curtailment of coverage. If there is a significant increase or decrease in the

cost of a benefit option during the plan year, election changes are permitted. For example, if there is a significant decrease in the cost of a benefit during the plan year, all eligible employees can be permitted to elect that benefit, including employees who elected another benefit option, or those who had elected not to participate in the benefit plan. Similarly, if a benefit option package is significantly improved mid-year, election changes are permitted. If there is a significant curtailment of coverage during the plan year, employees can be permitted to elect another benefit package offering similar coverage. Notably, the regulations specifically state that the loss of a particular physician in a network does not rise to the level of a significant curtailment of coverage. Only if the employer does not offer similar coverage, can an employee be permitted to drop coverage altogether in response to a curtailment of coverage.

Tax Withholding on Exercise of Stock Options Postponed to 2003

In Notice 2001-14, 2001-05 IRB, the IRS announced that it would postpone mandatory withholding on the exercise of statutory stock options to January 1, 2003. FICA, FUTA and income tax withholding will not be applied to the exercise of such options and additional guidance will be issued in the future. Statutory stock options refer to incentive stock options under Internal Revenue Code Section 422(b) and stock purchased under an employee stock purchase plan under IRC Section 423(b). This Notice also applies retroactively.

Department of Labor Guidance on Employee Benefit Plan Expenses

On January 19, 2001, the Department of Labor issued a new guidance clarifying the circumstances under which employee benefit plans may properly pay certain expenses relating to tax qualification and other activities. The guidance reaffirms the Department of Labor's view that so called "settlor function expenses" are not reasonable expenses of a plan. This guidance comes at a time when several Department of Labor field offices have been actively auditing the expenses paid by plans and challenging many of them.

The guidance clarifies that the initial creation of a plan and the tax qualification thereof is a settlor activity, which cannot be paid for by the plan. However, the maintenance of the tax qualified status of a plan, including amendments thereto, nondiscrimination testing and requesting future IRS determination letters (in most cases) would be expenses properly payable by a plan. However, the analysis of various options for amending a plan and the adoption of amendments to a plan which are not required for tax qualification, such as adding a loan program to a plan, would not be expenses properly payable by a plan.

Although this guidance provides significantly more information than previously given by the Department of Labor on these issues, there are still a number of issues that are not addressed. An employer should carefully analyze any and all expenses that are intended to be paid by the plan prior to actually having the plan reimburse those expenses. The improper payment of expenses by a plan is a prohibited transaction, which not only must be undone, but would also involve a 15% excise tax.

IRS Simplifies Distribution Rules

As reported in the last issue of e-News, the IRS has issued new regulations that significantly change how distributions are calculated under retirement plans and IRAs. Under existing rules, a retired plan participant must make numerous elections in order for a plan administrator to determine the minimum amount that must be distributed to that participant. The interplay of these elections is confusing to participants and plan administrators alike and often results in incorrect and inconsistent calculations.

The new rules greatly simplify the manner in which minimum distributions are calculated. The distribution period is the same for all persons of the same age. One uniform table is used to determine minimum distributions. In most cases, the table will result in a reduced minimum distribution, increasing the amount of money that participants can keep in the plan to accumulate tax free. The minimum amount payable to participants is simply determined based on the participant's age and his or her account balance. The only exception to this general rule is for a participant who has a spouse who is more than ten younger and who is the participant's sole beneficiary. In that case, actual life expectancy is used, not the uniform distribution table. After a participant's death, the remaining balance in a defined contribution plan can be distributed over the remaining life expectancy of the designated beneficiary.

The new rules are effective January 1, 2002, but can be used for distributions in 2001.

IRS Issues Split-Dollar Life Insurance Guidance

In Notice 2001-10, the IRS issued new guidance concerning split-dollar life insurance policies where the employer and employee join in the payment of the premiums on a policy on the life of an employee.

Previously, in the typical equity split-dollar arrangement, the employer would pay the premiums and receive an interest in the policy equal to the cash surrender value of the policy. Upon surrender of the policy or upon the employee's death, the employer would be repaid either the amount of the premiums advanced or would receive an amount equal to all or part of the cash surrender value, as the parties had agreed. For income tax purposes, the employee would be deemed to have received, on an annual basis, income equivalent to the P.S. 58 cost or the insurer's premium rate for one-year term insurance.

In summary, Notice 2001-10 substantially revises this treatment. Now, the employer's payments will generally be classified as loans to the employee under Internal Revenue Code Section 7872. As a result, if adequate interest is not charged, the payments will be treated as below-market loans and the difference between the interest actually charged and the Applicable Federal Rate (AFR) will be treated as income to the employee and as interest

paid by the employee to the employer. The employee would not have additional income beyond this amount unless the loans were not repaid in accordance with their terms or the employee actually receives distributions under the policy.

The IRS will generally accept the parties' characterization of the employer's payments as loans under a split-dollar arrangement if certain reasonable requirements are met. These include consistency with the substance of the arrangement, consistency in following the arrangement and accounting fully for all economic benefits conferred on the employee in a manner consistent with the loan characterization.

On the other hand, if the payments are not consistently treated as loans, the tax consequences will be more significant. The employer will be treated as having beneficial ownership of the policy; the employee will be deemed to have compensation income equal to the value of the life insurance protection; the employee will be deemed to have compensation income equal to any dividends or similar distributions (including amounts used to buy additional policy benefits); and the employee will have compensation income under IRC Section 83(a) to the extent the employee acquires a substantially vested interest in the cash value of the policy (reduced by any amount paid by the employee).

The P.S. 58 table is revoked and is replaced by Table 2001, a schedule of one-year term premiums which the parties are permitted to use in the absence of a valid table from the insurer for policies which are actually issued and available to insureds.

Note that if neither a loan arrangement nor the employer's beneficial ownership is involved, then the employee will be deemed to have received compensation income to the extent of the full amount of the premium paid by the employer.

Proposed Regulation Deals with Notice to Interested Parties

Notice of a request for a determination letter on the qualified status of a retirement plan must be provided to qualified interested parties before the IRS will act on the request. Interested parties are defined as employees with accrued benefits, former employees with vested benefits and beneficiaries of deceased former employees. Proposed Regulations issued by the IRS on January 17, 2001 under IRC Section 7476 do not change the standards for the content of the notice or the time in which it must be delivered, but they do allow for more methods of delivery of the notice, including provisions for electronic delivery. The same flexibility is permitted for notification of a collective bargaining representative in such circumstances. This notice, which is generally provided through posting, may be provided by any method that reasonably ensures that all interested parties will receive timely and adequate notice. The electronic method must meet the requirements of Proposed Regulation Section 1.402(f)-1, Question and Answer Number 5, which mandates that it: be reasonably accessible to the distributee; be as understandable as a written paper document; and be available in written form upon request of the distributee at no additional charge. Besides being required by the IRS before it will issue a determination letter, such notice is also required in order for an applicant to invoke the jurisdiction of the U.S. Tax Court if the IRS

refuses to issue a favorable determination.

Presidential Request for Regulatory Review

By White House Memorandum dated January 20, 2001, subject to review and approval by a department or agency head appointed by President Bush, all executive branch departments and agencies were instructed to withhold any proposed or final regulations from publication in the Federal Register and to withdraw any that had been submitted but not yet published. Further, the effective dates of any regulations which have been published but are not yet effective are to be postponed for a sixty-day period. There are exemptions for regulations under statutory or judicial deadlines and an intention is expressed to expedite those regulations that impact critical health and safety functions of the agencies. While it is anticipated that administrative pronouncements, such as IRS Notices, will not fall within these instructions, it is not possible to be certain of the exact scope of the White House Memorandum at this time.

For more information, please contact us

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