

IRS Issues New Proposed Cafeteria Plan Regulations

On August 6, 2007, the Internal Revenue Service (IRS) published new proposed regulations on cafeteria plans (“proposed regulations” – for a copy visit <http://edocket.access.gpo.gov/2007/pdf/E7-14827.pdf>). The proposed regulations explain, clarify and modify prior proposed and temporary regulations and regulatory guidance. The IRS withdrew the older proposed and temporary rules and announced these new proposed regulations shall replace the withdrawn regulations.¹ Much of the prior guidance in this area was adopted in the regulations. The new proposed regulations are effective January 1, 2009, but may be relied upon for guidance until final regulations are issued. The following summarizes the five sections of the new proposed regulations

General Rules on Qualified and Nonqualified Benefits in a Cafeteria Plan (New Proposed Reg. § 1.125-1)

SECTION 125 EXCLUSIVE RULE

The proposed regulations clarify the general rule that section 125 is the exclusive means by which an employer can offer an employee a choice between taxable and nontaxable benefits without the choice itself resulting in inclusion in gross income by the employee. Unless the election is made through a cafeteria plan that satisfies section 125 rules and regulations or another specific Code section (such as section 132(f)(4) – transportation fringe benefits) any opportunity to elect among taxable or nontaxable benefits results in the inclusion of the taxable benefit in income.

DEFINITION OF A CAFETERIA PLAN

A cafeteria plan is:

- A written plan that complies with the requirements of section 125 and the regulations,
- Maintained by an employer for the benefit of employees, and
- Operates in compliance with the requirements of section 125 and the regulations.

The participants of a cafeteria plan must be employees of the employer and the plan must offer at least one permitted taxable benefit (i.e. cash) and one qualified benefit. Additionally, a cafeteria plan must not defer compensation.

EMPLOYEE FOR PURPOSES OF SECTION 125

All cafeteria plan participants must be employees. The proposed regulations clarify the definition of an employee to include any current or former employees (including laid-off or retired employees) of the employer. While former employees may participate, a cafeteria plan may not predominantly benefit former employees of the employer.

The term employee includes:

1. Common law employees
2. Leased employees
3. Full-time life insurance salesman

¹ The proposed regulations issued May 7, 1984, December 31, 1984, March 7, 1989, November 7, 1997 and March 23, 2000 have been withdrawn.

The proposed regulations reflect the new definition of a dependent under section 152. A spouse or dependent of the employee may not be a participant in the cafeteria plan, even though the spouse or dependent may benefit from the plan. Further, the spouse or dependent may not make, revoke or change elections.

Consistent with prior regulations, a self-employed individual is not an employee for purposes of section 125. Self-employed individuals include a sole proprietor, 2% shareholder in an S- corporation, partner in a partnership or director solely serving on the board of directors for an employer. While they cannot participate in a cafeteria plan, self-employed individuals may sponsor a plan for their employees. The proposed regulations afford an individual who has dual status (i.e. the individual is an employee of the employer and provides services as an independent contractor or director) the ability to participate in the cafeteria plan solely in his/her capacity as an employee.

WRITTEN PLAN DOCUMENT REQUIREMENT

The proposed regulations clarify and expand the requirements of a written cafeteria plan.

The cafeteria plan document must be in writing and must be adopted and effective on or before the first day of the cafeteria plan year. Terms of the cafeteria plan must apply uniformly to all participants and the plan must operate in compliance with the written plan.

The regulations state the following must be included in a written plan document:

- Description of the benefits available through the plan including the period of coverage in which the benefits are provided;
- Plan rules governing participation, including specific language that all participants must be employees;
- Procedures governing employee elections, including when elections are made, period in which elections are effective and the requirement that elections are irrevocable except to the extent the change in status rules apply (change in status rules are provided in § 1.125-4);
- Manner in which employer contributions are made under the plan (i.e. employee salary reduction, employer contributions, or both);
- Maximum amount of employer contributions available to any employee through the plan; and
- The plan year of the cafeteria plan.

In addition, if the cafeteria plan provides any of the following components, the plan document must include specific language in order to be compliant:

- Plans offering paid time off must include language on the required ordering rule and cashout or forfeiture;
- Plans providing flexible spending arrangements (FSA) must include provisions for complying with the uniform coverage rule and the use it or lose it rule;
- If the plan provides a grace period, it must include required language applicable to the grace period;
- If the plan permits distributions from the FSA to an HSA, proper plan amendments and language must be contained in the written plan.

A plan that does not comply with the written plan document requirement fails to be a cafeteria plan.

ELECTION BETWEEN TAXABLE AND QUALIFIED NONTAXABLE BENEFITS

A cafeteria plan must offer employees the opportunity to elect among permitted taxable benefits and qualified nontaxable benefits.

Permitted Taxable Benefits

Permitted taxable benefits include cash and certain other taxable benefits treated as cash for purposes of section 125. Cash means cash compensation (including salary reduction), payment for annual leave, sick leave, other paid time off, severance pay, property and certain after-tax employee contributions. Other taxable benefits treated as cash are property, benefits attributable to employer contributions that are currently taxable to the employee upon receipt by the employee and benefits purchased with after-tax employee contributions.

Qualified Benefits

A qualified benefit under section 125 must be excludable from the employee's gross income under a specific provision of the Internal Revenue Code (Code) and must not defer compensation. Qualified benefits include:

- Employee group term life insurance (section 79);
- Employer provided accident & health plans (including FSA), accidental death & dismemberment policies; (sections 106 & 105)
- Dependent care assistance; (section 129)
- Adoption assistance program; (section 137)
- Contributions to a section 401(k);
- Contributions to certain plans maintained by education organizations; and
- Contributions to health savings accounts (HSAs).

PLAN YEAR REQUIREMENTS

Under the proposed regulations, a cafeteria plan year must be 12 consecutive months, unless a short plan year is permitted. The regulations clarify a short plan year is permissible only for valid business purposes. A change in plan year for the principal purpose of circumventing section 125 rules or the regulations is prohibited.

GRACE PERIOD

The regulations include the optional provision of a two month and fifteen day grace period immediately following the end of each plan year, as provided by IRS Notice 2005-42.² The regulations clarify the grace period may apply to all qualified benefits under the cafeteria plan except paid time off and elective 401(k) contributions. The grace period must be applied uniformly to all participants in the cafeteria plan on the last day of the plan year (including COBRA qualified beneficiaries with coverage as of the last day of the plan year). Implementing a grace period requires an amendment to the cafeteria plan written document.

² See *K&P Technical Bulletin May 2005* <http://www.kpcom.com/newsletters/documents/UseorLoseIt52005.pdf>;

see also *IRS Notice 2005-42* <http://www.treasury.gov/press/releases/reports/n0542.pdf>

The written document must state unused benefits or contributions relating to a particular qualified benefit may be used only to pay or reimburse expenses incurred for the same benefit (i.e. cannot use remaining dependent care FSA dollars to reimburse qualified medical expenses). Benefits or contributions remaining at the expiration of the grace period are still subject to the use it or lose it rule and will be forfeited.

GROUP TERM LIFE INSURANCE

Group term life insurance is a qualified benefit that may be offered under a cafeteria plan. Under Code section 79, up to \$50,000 in life insurance is excludable from the gross income of employees. However, if group term life insurance provided to the employee by an employer (including coverage provided through a cafeteria plan) exceeds \$50,000 then the cost of the coverage in excess of the \$50,000 is included as income to the employees.

The new proposed regulations provides that the cost of group term life insurance in excess of \$50,000 offered through a cafeteria, is calculated based on the Table I cost of excess coverage minus any after-tax contribution. (1.79-3(d)(2), Table I). The entire amount of pre-tax salary reduction or employer flex credits is excludable from the employee's gross income. This differs from prior guidance that stated the cost of coverage was the greater of the Table I cost or the employee's actual cost under the cafeteria plan. Guidance on group term life insurance taxation is effective immediately.

INDIVIDUAL INSURANCE AND COBRA PREMIUMS

The proposed cafeteria plan regulations permit pre-tax premium payment of an employee's substantiated individual accident and health insurance premiums. Additionally, COBRA premiums may be paid on a pre-tax basis through a cafeteria plan. It is important to note that there are other legal requirements (ERISA, HIPAA) that must be considered prior to implementing this provision under the cafeteria plan.

PAID TIME OFF

Elective paid time off (vacation days, sick days or personal days) is a permissible taxable benefit under a cafeteria plan. Many employers offer this benefit as a way for employees to "buy" more time off than what is provided by the employer on a non-elective basis. If offered under the cafeteria plan, the proposed regulations require that employees use up the non-elective paid time off first and then the elective paid time off. If an individual does not use all of their elective paid time off by the end of the plan year, the cafeteria plan must provide that the elective paid time off is either paid in cash on or before the last day of the plan year, or forfeited on the last day of the plan year. An employee cannot use paid time off or receive cash in a subsequent year, as doing so would violate the prohibition on deferred compensation. Additionally, the grace period does not apply to paid time off benefits.

MANDATORY TWO-YEAR ELECTION FOR VISION OR DENTAL INSURANCE

Some vision and dental insurance contracts require a mandatory two-year coverage period ("two-year lock-in"). The proposed regulations state the two-year lock-in will not result in deferred compensation provided the premiums for each plan year are paid no less frequently than annually and any salary reduction or flex credit relating to the first year of coverage does not apply to the second year of coverage. A lock-in may not exceed two years under the proposed rules.

PAYING PREMIUMS FOR THE FIRST MONTH OF THE PLAN YEAR WITH SALARY REDUCTIONS FROM THE LAST MONTH OF THE PRIOR PLAN YEAR

Salary reduction amounts from the last month of a cafeteria plan year may be applied to pay accident and health insurance premiums during the first month of the immediately following plan year, provided it is done on a uniform and consistent basis for all plan participants.

NONQUALIFIED BENEFITS

The proposed regulations clarify some of the benefits that may not be offered under a cafeteria plan:

- Scholarships (section 117),
- Employer provided meals and lodging (section 119),
- Educational assistance (section 127),
- Fringe benefits (section 132),
- Long-term care insurance and services,
- Contributions to a Archer Medical Savings Account (sections 220, 106(b)),
- Group term life insurance of an employee's spouse, child or dependent,
- Health Reimbursement Arrangements (HRA), and
- Elective deferrals to section 403(b) plans

A plan offering any of these benefits is not a cafeteria plan.

AFTER-TAX EMPLOYEE CONTRIBUTIONS

A cafeteria plan may offer after-tax contributions for qualified taxable benefits or paid time off. This is an option under the regulations and not a requirement. Non-qualified benefits may not be offered through the cafeteria plan even on an after-tax basis.

Examples of this include:

- A cafeteria plan where an employee may elect to purchase long-term disability coverage with after-tax employee contributions, or
- A cafeteria plan that permits an employee to purchase with after-tax employee contributions group term life insurance on the life of the employee or an accident or health plan.

EMPLOYER CONTRIBUTIONS TO A CAFETERIA PLAN

Employer contributions are amounts not currently available to the employee but are specified in the cafeteria plan as amounts that an employee may use to elect benefits through the plan.

Salary reduction contributions are employer contributions, as employees elect to forgo salary to receive a benefit that is excludable from income because it is provided by employer contributions. Employer flex-credits are employer contributions that are made on the employee's behalf in specified amounts for the election of benefits offered under the plan.

The proposed regulations permit a cafeteria plan to impose reasonable fees to administer the cafeteria plan which may be paid through salary reduction.

Elections in Cafeteria Plans (New Proposed Reg. 1.125-2)

MAKING, REVOKING AND CHANGING ELECTIONS

Employees must make annual elections before the earlier of the first day of the period of coverage or when benefits become currently available.

The proposed regulations maintain the requirement that cafeteria plan elections are irrevocable for the plan year unless the plan provides for a change in election based on permitted changes in status. 26 CFR § 1.125-4. The change in status rules must be contained in the written cafeteria plan document.

AUTOMATIC ELECTIONS

The proposed regulations permit (but do not require) automatic elections for new employees or current employees who fail to timely elect benefits. The cafeteria plan rules will permit an automatic or “evergreen” election for employees for one or more qualified benefits. For example, an election made in any prior year is deemed to be continued for every succeeding plan year, unless changed. There are certain notice obligations that are required prior to implementing an automatic election process.

New employees have a 30-day grace period after the date of hire to make a cafeteria plan election (even if the benefits are available on the date of hire). The salary amounts to pay for the election must be from compensation not yet currently available on the day of the election. This does not apply for employees who terminate employment and are rehired within 30 days.

HSA CONTRIBUTIONS

Employers may permit participants to make HSA contributions through the cafeteria plan. The HSA contribution must be included in the written plan document and must allow participants to prospectively elect, revoke or change salary reduction contributions on a monthly basis (or more frequently).

ELECTRONIC ELECTIONS

New elections, revocations or election changes may be made electronically. The safe harbor for electronic elections in 1.401(a)-21 applies to cafeteria plan elections. The rule for participant elections requires that:

- the participant be effectively able to access the electronic system used to transmit the electronic election,
- the electronic system is reasonably designed to preclude any person other than the appropriate individual from making the election (for example, through the use of a personal identification number),
- the system provides a reasonable opportunity to review, confirm, modify or rescind the terms of the election before it becomes effective, and
- the participant making the election receives confirmation of the election within a reasonable time period, via a system that either meets the affirmative consent and disclosure requirements or the exemption from the consent requirements, as detailed in § 1.401(a)-21(b) and (c).

Flexible Spending Arrangements (FSA) (new Proposed Reg. § 1.125-5)

UNIFORM COVERAGE RULE

The proposed regulations retain the uniform coverage rule and require that the maximum amount of reimbursement from an health FSA must be available at all times during the period of coverage. This rule does not apply for dependent care or adoption assistance FSAs.

USE IT OR LOSE IT RULE

The proposed regulations retain the use it or lose it rules, requiring any benefits and contributions not used by the end of the plan year (or grace period if applicable) are forfeited.

PERIOD OF COVERAGE

The period of coverage for all FSAs remains 12 months unless a short plan year applies (see above). The period of coverage and the plan year do not need to be the same. The health FSA and dependent care FSA may have a separate coverage period that may differ from the cafeteria plan year.

HEALTH FSA

A health FSA is a medical reimbursement plan under section 105 and must comply with section 105(h) nondiscrimination requirements. The health FSA may only reimburse certain substantiated section 213(d) medical care expenses incurred by the employee or the employee's spouse or dependents. The proposed regulations permit a health FSA to be limited to a subset of permitted section 213(d) expenses. The FSA may not reimburse health or accident insurance premiums or long-term care insurance.

FSA ADMINISTRATIVE RULES

The proposed regulations permit limiting enrollment in a health FSA to those employees who participate in an employer's accident and health plan.

ADVANCE ORTHODONTIA PAYMENTS

Advance payments for orthodontia are permitted if the employee actually made payments in advance of the orthodontia services in order to receive the services.

HSA COMPATIBLE HEALTH FSAS

A general purpose health FSA is not a qualified high deductible health plan (QHDHP) and will disqualify an individual from contributing to a Health Savings Account (HSA). The regulations provide for two FSA options that maintain HSA eligibility. A limited purpose health FSA reimburses only permitted coverage benefits like vision, dental or preventive care. A post-deductible health FSA reimburses medical expenses incurred after the minimum qualified high deductible is satisfied. The regulations permit a combined limited purpose health FSA and post-deductible health FSA. All claims must comply with substantiation requirements under the proposed regulations.

QUALIFIED HSA DISTRIBUTIONS

The proposed regulations incorporate the rules on qualified HSA distributions provided in Notice 2007-22 (2007-10 IRB 160).³

EXPERIENCE GAINS

Experience gains may be treated in the following manner:

- Retained by the employer
- Used to defray administrative cost of the plan
- Allocated among employees on a reasonable and uniform basis. The allocation of experience gains may be based on different coverage levels of the employee. However, the allocation may not be based on an individual's claims utilization.

Substantiation of Expenses for All Cafeteria Plans (New Proposed Reg. § 1.125-6)

CAFETERIA PLAN PAYMENTS AND REIMBURSEMENTS

A cafeteria plan may pay or reimburse only those substantiated expenses for qualified benefits incurred on or after the effective date of the cafeteria plan and the date of the employee's enrollment on the plan.

INCURRED MEDICAL EXPENSES

Expenses are incurred when the employee (or spouse or dependent) is provided with medical care that gives rise to the medical expense, not when the employee is billed, charged or pays for medical care.

INCURRED DEPENDENT CARE EXPENSES

Dependent care expenses are incurred when the care is provided, not when the employee is billed, charged or pays for the expense.

DEPENDENT CARE ASSISTANCE AFTER TERMINATION

The proposed regulations provide for an optional spend-down provision with respect to the dependent care FSA. Dependent care expenses incurred after the date an employee ceases participation in the employer's cafeteria plan may be reimbursed from unused benefits if all section 129 requirements are satisfied. This provision essentially provides the former employee the opportunity to "use-up" any remaining dependent care funds in the FSA for otherwise eligible expenses during the plan year. Amounts remaining at the end of the plan year (or grace period if applicable) are forfeited under the use it or lose it rule.

³ See K&P Technical Bulletin February 2007, <http://www.kpcom.com/newsletters/documents/IRSIssuesGuidanceonQualifiedHSA.pdf>;

see also IRS Notice 2007-22 <http://www.irs.gov/pub/irs-drop/n-07-22.pdf>

CLAIMS SUBSTANTIATION

An independent third party must substantiate all claims. Substantiation must include a description of the service or product, date of the service or sale and the amount. Reimbursing an expense before the service is incurred or substantiated is impermissible.

DEBIT CARDS

The proposed regulations incorporate previous guidance on the use of a debit card to pay, substantiate and reimburse qualified expenses. It also expands on the provisions accounted for in Notice 2006-69 and Notice 2007-2.⁴ Unfortunately, there remains a significant administrative burden associated with implementing a debit card component to the FSA.

- Before the employee receives a health FSA debit card he/she must agree in writing to the following:
 - That the debit card will only be used to pay for medical expenses (as defined by section 213(d)) of the employee, spouse and/or dependent.
 - That the debit card will not be used for expenses that have already been reimbursed,
 - That he/she will not seek reimbursement under any other health plan for any expense paid with the debit card, and
 - That he/she will acquire and retain sufficient documentation to substantiate any expense paid with the debit card.
- The debit card must contain a statement providing that the above provisions have been agreed to in writing, and are reaffirmed each time the employee uses the card.
- The amount available must equal the employee's annual election (uniform coverage rule applies), and is reduced by amounts paid or reimbursed for medical expenses incurred during the year.
- The card must be automatically cancelled when the employee ceases participation in the health FSA.
- The employer limits the use of the debit card to:
 - Medical Care Providers (physicians, dentists, hospitals, etc.)
 - Stores with merchant category codes (MCC) for drugstores and pharmacies if such stores meets the 90% gross receipts test for items that qualify as section 213(d) expenses, and
 - Stores that have implemented the inventory information approval system.
 - The employer substantiates claims in compliance with the regulations, and
- The employer follows proper correction procedures for improper payments as outlined in the proposed regulations.

The regulations permit substantiation for expenses that are copay matches (exact multiples of five or fewer), recurring expenses and real-time substantiation. The proposed regulations permit point-of-sale substantiation when the inventory information approval system matches the expense with a list of § 213(d) expenses. The employer is responsible to ensure that the inventory information approval system meets the requirements of the new regulations.

4 IRS Notice 2006-69 <http://www.irs.gov/pub/irs-drop/n-06-69.pdf> and IRS Notice 2007-02 <http://www.irs.gov/pub/irs-drop/n-07-02.pdf>

Debit cards may be used to pay dependent care expenses. A dependent care FSA may not reimburse the expense until the service is provided. For example, a payment for dependent care services for September 1 – 30 may not be reimbursed until September 30. This is the case even when the service provider requires advanced payment. The regulations do permit automatic substantiation of recurrent expenses when transactions are for an amount equal to or less than the previous expenses. However, if the amount is more, the expense will need to be re-substantiated.

The effective dates of prior guidance (Notice 2006-69 and Notice 2007-2) remain in effect. Under the transition relief in Notice 2007-2, health FSA debit cards may be used at stores with a merchant category code for a drug store or pharmacy until December 31, 2008, without having to satisfy the 90% receipt or inventory information approval system requirement. Debit cards may not be used after December 31, 2007 at supermarkets, grocery stores, discount stores, wholesale club, mail order or other web-based vendor that do not have a merchant category code related to health care, unless the vendor or merchant implemented the approved inventory information approval system. The proposed regulations are effective January 1, 2009.

Cafeteria Plan Nondiscrimination Rules (New Proposed Reg. § 1.125-7)

The new regulations provide additional guidance on the nondiscrimination rules under section 125. In particular, the regulations define key terms including highly compensated individual or participant, key employee, officer, and 5% shareholder. The regulations provide guidance on the eligibility nondiscrimination test by incorporating the reasonable classification, safe harbor percentage and unsafe harbor percentage test under section 410(b). Additionally, for purposes of the contribution & benefits test under section 125, the regulations provide a new objective test to determine when the actual election of benefits is discriminatory. The proposed regulations state that a cafeteria plan must give each similarly situated participant a uniform opportunity to elect qualified benefits, and that highly compensated participants must not actually disproportionately elect qualified benefits. New to nondiscrimination testing is a safe harbor for premium only plans that satisfy certain requirements. Also, the regulations specify that nondiscrimination testing must be completed on the last day of the plan year taking into account all non-excludable employees (and former employees) employed during the plan year.

Proposed Effective Date

The regulations apply beginning on or after January 1, 2009, subject to a few exceptions. The group term life insurance portion of the regulation is effective immediately. In addition, the effective dates of earlier guidance on debit cards remain in place (see above). Employers may rely on the new proposed regulations for guidance until final regulations are issued.

Action Items

For now, employers should consider reviewing their cafeteria plan document in light of the announced changes. It will be important that the cafeteria plan conforms to the written plan document requirements as outlined in the proposed regulations. In addition, for employers sponsoring cafeteria plans that currently provide life insurance through the plan, they will want to implement the new Table I calculation of the cost of coverage in excess of \$50,000. Further, employers offering grace periods, HSA contributions, qualified HSA distributions or debit cards will want to make sure there are appropriate amendments and language in the cafeteria plan document. As always, your Kibble & Prentice service team can assist you through this process. We will keep you updated with any additional information that develops from the release of the proposed regulations.