

# IRS PROPOSES NEW CAFETERIA PLAN REGS

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The IRS has just made a significant move in withdrawing over two decades worth of temporary and proposed cafeteria plan regulations and, in their place, issuing new proposed regulations which greatly impact current cafeteria plan designs and administration.

The proposed regulations, which were published in the Federal Register on August 6, 2007, clarify numerous provisions of the previous regulations, describe how a plan will lose its qualified status, expand the nondiscrimination requirements, and incorporate newer changes in the law, such as:

- the change in the definition of dependent under the Internal Revenue Code;
- the addition of qualified benefits, namely:
  - adoption assistance;
  - health savings accounts; and
  - qualified HSA distributions from health FSAs;
- the prohibition against long-term care insurance and services; and
- the addition of the key employee concentration test in the nondiscrimination rules.

At the forefront of this guidance, the IRS strongly reiterates the written plan requirement. If an employer offers its employees a choice between taxable and nontaxable benefits (ie, reducing taxable salary to receive nontaxable health or other benefits), the employees are nevertheless taxed if a written document is not in place.

Although the majority of the new proposed rules are not to become effective until January 1, 2009, the IRS withdrawal of the previous temporary and

proposed cafeteria plan regulations means that there is not much other guidance to rely upon but these new proposed rules. The IRS actions are significant and represent that the Service will likely begin paying more attention to cafeteria plan compliance and nondiscrimination testing. Employers therefore must ensure that their plan documents and operations are properly prepared for strict scrutiny by the IRS.

Specifically, the new proposed sections of the regulations are<sup>1</sup>:

- §1.125-1 - Cafeteria plans; general rules
- §1.125-2 - Cafeteria plans elections
- §1.125-5 - Flexible spending arrangements
- §1.125-6 - Substantiation of expenses for all cafeteria plans
- §1.125-7 - Cafeteria plan nondiscrimination rules

While by no means exhaustive, below you will find a summary of highlights from the updated IRS guidance.

## **Prop. Treas. §1.125-1—Qualified and Nonqualified Benefits in Cafeteria Plans**

A Section 125 cafeteria plan “is the exclusive means by which an employer can offer employees a choice between taxable and nontaxable benefits without the choice itself resulting in inclusion in gross income by the employees.” Preamble, p 6. The plan must be a written plan in which the only participants are employees, which includes former employees (but not spouses or dependents, although they may “benefit” from the employees’ participation).

*(continued on page 2)*

<sup>1</sup> The sections regarding permitted mid-year election changes (Treas. Reg. § 1.125-4) and the effect of the Family and Medical Leave Act on cafeteria plans (Treas. Reg. § 1.125-3) remain completely intact.

Written Document and Qualified Status

If a cafeteria plan is not in writing and is not operated in accordance with its terms, the plan will lose its qualified status, resulting in all employees being taxed as if they had chosen the taxable benefits available to them. The proposed regulations include ten specific items that must be included in the plan documentation. Additionally, a plan will also fail to satisfy the Section 125 requirements if it:

- offers nonqualified benefits (such as long-term care insurance or services, Archer MSAs, or dependent group-term life);
- does not offer an election between at least one permitted taxable benefit and at least one qualified benefit;
- defers compensation;
- fails to comply with the uniform coverage rule or use-it or lose-it (ie, forfeiture) rule;
- allows employees to revoke elections or make new elections during a plan year, except as provided in §1.125-4;
- fails to comply with the substantiation requirements;
- pays or reimburses expenses incurred for qualified benefits before the effective date of the cafeteria plan or before a period of coverage;
- allocates experience gains (forfeitures) other than as expressly allowed in the new proposed regulations; and
- fails to comply with grace period rules.

Twelve Month Plan Year

The proposed rules include the requirement that a plan year must be twelve months and provide that short plan years are allowed for a valid business purpose, as described in the regulations.

Group-Term Life Insurance

The proposed regulations also modify the Notice 89-110 rules on how group-term life insurance in excess of \$50,000 is taxed to employees. Notice

89-110 provided that an employee is taxed on the greater of the Table I (under § 79) cost of group-term life insurance coverage exceeding \$50,000 or the employee’s salary reduction and employer flex-credits for such excess group-term life insurance coverage. However, the new proposed regulations provide that the employee is taxed on the Table I cost of the excess coverage alone (minus any after-tax contributions by the employee). No consideration is made for any salary reduction or employer flex-credits which are excludible from the employee’s gross income. While the majority of these regulations become effective on January 1, 2009, the provisions regarding group-term life become effective immediately.

Individual and COBRA Premiums

Under the new proposed regulations, a cafeteria plan (but not a health FSA) may pay or reimburse substantiated individual accident and health insurance premiums. However, until further guidance is issued, we caution employers regarding this provision as it could run afoul to HIPAA’s nondiscrimination rules as well as have ERISA implications. Additionally, cafeteria plans may provide for the payment of COBRA premiums for an employee.

Practices Found Not To Defer Compensation

Benefits and plan administration practices that defer compensation are not allowed to be funded through a cafeteria plan. Whether some benefits fell into this category was questionable, and the new proposed regulations provide needed clarification. For example, a sampling of benefits and/or practices under the new rules that do not defer compensation and therefore can properly be included in a cafeteria plan include:

- certain two-year lock-in vision and dental policies (as long as premiums are paid at least annually and are applicable for coverage in that same year);
- certain advance payments for orthodontia;

*(continued on page 3)*

- salary reduction contributions in the last month of a plan year used to pay accident and health insurance premiums for the first month of the following plan year.

However, life insurance with a cash value build-up or with a permanent benefit does defer compensation and therefore cannot be offered under a cafeteria plan.

After-Tax Contributions and Administration Fees

An employee may pay for qualified benefits with after-tax contributions. Moreover, the new rules provide that a plan may impose reasonable administration fees on employees, which may be paid through the plan on a pre-tax basis.

**Prop. Treas. §1.125-2 – Election in cafeteria plans**

New Employee Retroactive Election

The proposed regulations allow cafeteria plans to provide retroactive coverage to the date of hire if new employees make their election within 30 days after their hire date, as long as the salary reduction is from compensation not yet available on the date of the election. This special election rule will not apply to terminated employees who are rehired within 30 days of their termination (or for employees returning to work after an unpaid leave of absence under 30 days).

New elections, revocations and changes in elections can be made electronically; however, certain safe harbor rules for electronic elections should be followed.

**Prop. Treas. §1.125-5-Flexible spending arrangements**

Adoption Assistance

In addition to the typical FSAs offered through cafeteria plans (dependent care assistance and medical care reimbursements), the new regulations

incorporate rules allowing for adoption assistance under §137 to also be provided through FSA arrangements.

Health FSA Limited Enrollment

Under the new rules, a cafeteria plan may limit enrollment in a health FSA to those employees who participate in the employer’s accident and health plan. However, we question whether this will cause any issues under the §105(h) nondiscrimination requirements for self-funded plans.

Post-Termination Reimbursement of Dependent Care Expenses

The new rules also incorporate provisions allowing an employer to reimburse a terminated employee’s qualified dependent care expenses incurred after termination (ie, allowing former employee’s to “spend down” their accounts) if all §129 requirements are otherwise satisfied.

Experience Gains

Amounts forfeited by employees at the end of the plan year (or upon termination of participation) are referred to as “experience gains.” The proposed regulations clarify that these experience gain may be retained by the employer (although ERISA plans are prohibited from retaining participant forfeiture under the exclusive benefit rule issues), can be used to defray expenses associated with administering the plan, or can be allocated among employees on a reasonable and uniform basis as described in the regulations.

Qualified HSA Distributions

The IRS has also incorporated the prior guidance on qualified HSA distributions. In order for employees to take advantage of this FSA rollover, the plan must be amended. Additionally, the following requirements must be met:

- no qualified HSA distribution has previously been made;

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- the employee elects to have the employer make the distribution from the health FSA to the HSA;
- the distribution does not exceed the lesser of the health FSA balance on:
  - September 21, 2006, or
  - the date of the distribution;
- the balance is computed on a cash basis (not taking into account expenses incurred but not reimbursed);
- the distribution is made no later than December 31, 2011; and
- the employer makes the distribution directly to the trustee of employee’s HSA.

If the employee is not eligible at the time of the distribution or during the following testing period (as described in the rules), the distribution amount is included in the employee’s gross income, plus a 10 percent tax (with certain exceptions). Moreover, even if the distribution results in a zero balance FSA, the FSA coverage continues until the end of the plan year, meaning that an employee attempting to make an HSA distribution mid-year will fail to be a qualified HSA individual. This is because she or he would still be enrolled in the FSA, which is disqualifying non-HDHP coverage.

**Prop. Treas. §1.125-6-Substantiation of expenses for all cafeteria plans**

This section is extremely important. If claims are not properly substantiated, all amounts paid under the cafeteria plan will be included in gross income. Self-substantiation of claims by employees is not proper; substantiation must be made by an independent third-party. Employers should review their cafeteria plan’s current payment procedures closely. If reimbursements are made without third-party verification (ie, with receipts or other acceptable methods through the use of debit cards), the plan’s qualified status will fail.

The previous guidance on debit card usage and substantiation is also incorporated in this section. One provided change allows card usage by COBRA qualified beneficiaries. Previous guidance stated

that debit cards automatically were canceled at termination of employment; the new regulations state that the cards will instead be canceled at termination of participation. As participation continues for those electing COBRA, conceivably those individuals can continue using their cards. Additionally, the plan sponsor (ie, typically the employer) has the duty to ensure such debit cards are used in accordance with the rules, so employers must pay close attention to the substantiation process.

**Prop. Treas. §1.125-7-Nondiscrimination rules**

Significantly, the IRS has provided much needed additional guidance on the cafeteria plan nondiscrimination rules, including:

- definitions of key terms;
- guidance on the eligibility test and the contributions and benefits tests, including an objective test to determine when the election of benefits is discriminatory;
- descriptions of employees allowed to be excluded from testing; and
- a safe harbor nondiscrimination test for premium-only-plans.

Unfortunately, many of the examples following the testing rules “muddy” the waters and appear to indicate discrimination will occur if the underlying benefits to highly compensated individuals are more generous, even if the eligibility and participation levels in the cafeteria plan itself are comparable. If so, employers across the board would have to re-evaluate their benefit packages, requiring redesign of benefit offerings to executives or taxation of such. However, as this would create mass chaos, we will await resulting commentary and publication of the final regulations before suggesting extreme action.

**Possible Cafeteria Plan Amendments**

Any employer offering a choice between taxable and nontaxable benefits will need to pay close attention to these new proposed regulations and

*(continued on page 5)*

the resulting commentary. The proposed regulations contain numerous anticipated clarifications, as well new rules which, if incorporated in the final regulations, will require amendments to cafeteria plans. If not already stated within an employer's plan documents, the following must be added:

- specific description of each underlying benefit, including the coverage periods during which each benefit is provided
- rules governing participation, including language specifying that only employees may participate in the plan
- timing and periods when elections may be made, when elections are effective, and setting forth the irrevocability rule
- whether benefits are purchased through salary reduction, employer flex credits or both
- calculation of the maximum monetary amount running through the plan
- the plan year
- if paid-time off is provided through the plan, the documents must describe the ordering rules for use of non-elective and elective paid time off
- if the plan provides FSAs, provisions complying with those FSA requirements under the regulations
- grace period requirements, if available under the plan, including the following:
  - that benefits unused at the end of the plan year may only be used to purchase the same qualified benefits during grace period (ie, dependent care funds only for dependent care expenses)
  - amounts remaining at the end of the grace period must be forfeited under the use-it or lose-it rule
- if FSA rollovers to HSAs ("qualified HSA distributions) are allowed, they must be provided for in an amendment and comply with the new regulations

In addition to those ten written requirements under the regulations, the new rules clarify and expand other concepts which must be included in amendments:

- changes in election for HSA pre-tax contributions must be allowed at least monthly (these mid-year changes in election are mandatory, not optional, thereby necessitating plan amendments for plans offering HSAs)
- plan language stating that employees are permitted to make elections among permitted taxable benefits and qualified benefits offered through the plan for the plan year
- a description of how the plan will handle experience gains (ie, forfeitures from FSAs)

Optional amendments include the following, if applicable:

- retroactive coverage for new employees who make an election within 30 days after their hire date
- payment for administrative expenses through the plan
- limiting health FSA participants to those in the employer's group health plan
- allowing advance payment for orthodontia if the employee actually makes payments in advance of receiving the services
- addition of an adoption assistance FSA
- inclusion of all debit card rules, if made available to employees, including changed language that the cards automatically terminate upon termination of participation (instead of termination of employment)

If you should have any questions regarding the above changes, please do not hesitate to contact us. We look forward to hearing from you.

*(Please see IRS Circular 230 Disclosure on page 6.)*

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*IRS Circular 230 Disclosure*

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