



FLEX-PLAN SERVICES IRS UPDATE THE NEW PROPOSED CAFETERIA PLAN REGULATIONS

On Monday, August 6, 2007, the Internal Revenue Service issued new proposed Income Tax Regulations under section 125 of the Internal Revenue Code (IRC). These regulations replace prior proposed regulations dating back to 1984. The prior proposed regulations provided the basic framework and requirements for cafeteria plans as well as the rules regarding health and dependent care flexible spending arrangements (FSA). The new regulations reflect changes in the law since the prior regulations were proposed and function to clarify and incorporate prior IRS guidance. These proposed regulations apply to plan years beginning on or after January 1, 2009. The following is a summary of keys points.

NEW PROPOSED §1.125-1 CAFETERIA PLAN; GENERAL RULES

CAFETERIA PLAN DEFINITION

A cafeteria plan is a separate written plan maintained by an employer for employees. The plan must provide a choice between taxable and qualified benefits, comply with section 125 and the regulations, and not defer compensation. Qualified benefits are benefits excludable from an employee's income under a specific provision of the IRC and do not defer compensation. Qualified benefits include: group term life of the employee; employer provided accident and health plans (e.g. Health FSA); accidental death and dismemberment policies; dependent care assistance programs; 401K contributions; contributions to certain educational organizations; and contributions to Health Savings Accounts (HSAs).

This definition reminds employee benefit administrators, brokers, and employers of the necessity of choice between taxable benefits and qualified benefits. Employers should review their plan design to ensure compliance.

WRITTEN PLAN

The new regulations impose specific written plan requirements. The cafeteria plan must specify that only employees may participate. Additionally, the written plan must describe all benefits, describe eligibility rules and procedures for making elections, provide that all elections are irrevocable, explain how employer contributions are made, and provide plan maximums and the plan year. If the plan incorporates a Health FSA, the plan must also describe the uniform coverage rule and the use-or-lose rule. All provisions of the written plan must apply to all participants uniformly.

If the plan is amended, that amendment must be in writing, occur during the plan year, and apply on the later of the effective date of the amendment or adoption date of the amendment. If the FSA provides a grace period, the plan must also describe grace period provisions and explain that unused benefits remaining at the end of the grace period cannot be carried forward to a subsequent plan year, cannot be cashed out, and must be forfeited. Because the new proposed regulations incorporate prior guidance most plan documents and

summary plan descriptions already comply with the new, more specific, written plan requirements; however, employers and administrators should check written plans to ensure compliance.

FAILING TO COMPLY WITH THE WRITTEN PLAN, SECTION 125 AND THE REGULATIONS

The IRS deems failing to comply with section 125, the regulations, or the written plan as an operational failure. Operational failures include: offering nonqualified benefits; not offering a choice between taxable and qualified benefits; permitting the deferral of compensation; failing to comply with the uniform coverage rule or the use-or-lose rule; allowing employees to revoke or make new elections (except as provided under the change in status regulations); failing to satisfy substantiation requirements; reimbursing expenses incurred before the plan's effective date or period of coverage; allocating experience gains other than as permitted by the new proposed regulations; and failing to comply with the grace period rules.

The regulations provide a list of nonqualified benefits. Nonqualified benefits include: scholarships; employer provided meals and lodging; education assistance; fringe benefits; long term care insurance; archer MSAs; group term life for a spouse or dependent; and elective deferrals for a 403(b). A plan that provides nonqualified benefits is not a cafeteria plan.

The result of an operational failure is that all nontaxable benefits elected by all participants would have to be included in gross income. Prior to these regulations, failing to comply with the written plan or the rules resulted in uncertain consequences. These regulations illustrate IRS intent to create clear expectations regarding compliance and impose significant adverse consequences for operational failures.

PLAN YEAR

The regulations clarify plan year requirements. The plan year must be twelve consecutive months and the plan year may begin on any day of any month. The regulations also provide that the employer may change the plan year "only for a valid business purpose" and that purpose cannot be to circumvent section 125 or the regulations. The employer must also have a valid business purpose to implement a short plan year. In an example, an employer was deemed to have a valid business purpose for a short plan year when he implemented a cafeteria plan mid-year to coincide with the taxable year and calendar year benefits.

GRACE PERIOD

The new proposed regulations clarify that the grace period can apply to some benefits but not others. Additionally, the regulations provide optional features for the grace period. The employer may limit the amount of unused benefits or contributions available during the grace period; that limit must be uniformly applied to all participants and must not be based on a percentage of unused benefits. The new proposed regulations also clarify that the grace period can be shorter than two and one half months. Employers may also regulate grace period reimbursements by deferring the allocation of expenses to the current year until after the grace period ends. Employers who desire to impose restrictions on reimbursement, implement shorter grace periods, or regulate allocation of expenses should check that the written plan authorizes such action.

Although the termination rules surrounding the grace period are not new the rule's technical application justifies reiteration. Grace period applies to all employees who were participants on the last day of the plan year. When an employee terminates employment during the grace period that employee may be reimbursed expenses incurred after their termination date, through the end of the grace period. However, if he or she was also a participant in the current year, the plan could not reimburse claims incurred after the termination date out of the current year.

INDIVIDUALS WHO MAY PARTICIPATE IN A CAFETERIA PLAN

All participants must be employees. Employees include common law employees, leased employees, and full-time life insurance salesman. The regulations provide that former employees are treated as employees for purposes of cafeteria plan participation; however, the plan may not be maintained "predominantly for the benefit" of former employees. The regulations clarify that self-employed individuals are not employees and may not participate in a cafeteria plan. Individuals who are not employees include: 2-percent shareholders of an S corporation, sole proprietors, partners in a partnership, and directors solely serving on a corporation's board of directors.

Interestingly, the regulations carve out a participation exception for certain dual status individuals. If an independent contractor or a director is also an employee, that employee may participate in the cafeteria plan in his or her capacity as an employee. Therefore, an employee who earns compensation as an employee and as a director may salary reduce his or her compensation as it relates to employee status, but cannot salary reduce compensation related to director status. This rule does not apply to 2-percent shareholders or partners.

INDIVIDUAL ACCIDENT AND HEALTH INSURANCE PREMIUMS (PREMIUM REIMBURSEMENT ARRANGEMENT)

The regulations specifically permit that payment or reimbursement of individual accident and health insurance premiums excludible from income is a qualified benefit. The employee must substantiate the expense before the plan provides reimbursement. The regulations also provide guidance regarding the permissible methods of reimbursement. The cafeteria plan can pay the employee as a direct reimbursement for substantiated health insurance premiums, issue a check to the employee payable to the health insurance company, or issue a check to the employee payable jointly to the employee and the insurance company.

PAYING COBRA PREMIUMS THROUGH A CAFETERIA PLAN

The new proposed regulations provide that COBRA premiums for an employer-provided group health plan are qualified benefits if they are excludible under section 106 or the premiums are for the accident and health plan of the employer sponsoring the cafeteria plan. The regulations provide two examples illustrating COBRA payment under a current and former employer's accident and health plan. In the first example an employee who was no longer covered by the employer's accident and health plan was permitted to salary reduce to pay COBRA premiums. In the second example, an employee was permitted to salary reduce COBRA premiums through the current employer's cafeteria plan for coverage under a former employer's accident and health plan.

USING SALARY REDUCTION AMOUNTS FROM ONE PLAN YEAR TO PAY PREMIUMS FOR THE FOLLOWING YEAR

The new regulations clarify plan administration practices that do not violate the prohibition against deferring compensation. Salary reduction amounts from the last month of the plan year may be used to pay accident and health insurance premiums in the first month of the immediately following plan year.

EMPLOYER CONTRIBUTIONS

Employer contributions are amounts not currently available to the employee but are specified in the cafeteria plan as amounts an employee may use for purposes of electing benefits. The regulations permit a plan to require an employee pay for qualified benefits with salary reductions and not with after-tax contributions. Additionally, the regulations clarify that a cafeteria plan is permitted to pay reasonable administrative fees through salary reduction.

§1.125-2 CAFETERIA PLANS; ELECTIONS

AUTOMATIC ENROLLMENT

The new proposed regulations permit a cafeteria plan to provide default (automatic) elections for new or current employees who fail to elect between permitted taxable and qualified benefits. Any plan intending to implement automatic elections should provide notice explaining automatic enrollment, the right to decline, salary reduction amounts for all benefits, and the deadline to opt out of automatic enrollment. Current employees should also receive a description of existing coverage and information indicating that coverage could continue each succeeding year. Employers must provide this notice before the plan year or coverage period.

Employers should avoid implementing automatic enrollment for health and dependent care flexible spending arrangements given that out-of-pocket expenses vary year-to-year and that the burden of complying with the notice requirements likely outweigh the convenience of conventional election methods.

OPTIONAL ELECTION FOR NEW EMPLOYEES

The regulations provide an optional new rule for plans with date-of-hire eligibility requirements. The new rule gives new employees 30 days from the date of hire to make an election between cash and qualified benefits. The election can relate back to the date of hire but the salary reduction amounts must be from compensation not yet currently available as of the election date. The written cafeteria plan must provide an exclusion from this special rule for any employee who terminates and is rehired within 30 days (or returns from unpaid leave within 30 days). This new rule essentially provides a 30 day election window and imposes written cafeteria plan requirements. The rule does not alter individual cafeteria plan eligibility requirements (e.g. plans with different eligibility requirements are not required to permit new employees enter the plan upon date of hire) and only applies to plans that permit new employees enter upon date of hire.

ELECTRONIC ELECTION

An employee is not required to make an election on written paper. Electronic elections are permitted but employers should ensure that the electronic medium satisfies the safe harbor regulations in §1.401(a)-21. Those regulations require that the electronic medium is accessible, the electronic medium has a reasonably designed system of authenticating the individual, and the electronic medium provides an opportunity to review, confirm, modify, or rescind the election. The participant must receive confirmation of the election on a written document or an electronic medium within a reasonable time. If confirmation is sent in electronic medium, that confirmation must also satisfy the electronic notice requirements contained in the regulations.

§1.125-5 FLEXIBLE SPENDING ARRANGEMENTS

DEFINITION OF FLEXIBLE SPENDING ARRANGEMENT

The definition of a flexible spending arrangement remains substantially unchanged. An FSA is a benefit program provided to employees which reimburses incurred, qualified benefits, up to a maximum amount of reimbursement. The new proposed regulations also provide that the cafeteria plan may limit enrollment in Health FSA to those employees who participate in the employer's accident and health plan. Additionally, the regulations clarify the rules regarding the timing of salary reduction contributions. Salary reduction contributions may be made at whatever interval the employer elects. That interval can be based on payroll periods or some other interval of equal installments and the rules must apply to all participants uniformly.

HEALTH FSA - UNIFORM COVERAGE RULE

The regulations retain and confirm that the maximum amount of reimbursement must be available at all times during the coverage period. Available at all times means that reimbursement must occur at least monthly or when the reimbursement reaches a reasonable minimum amount. The amount reimbursable cannot relate to the amount contributed and salary reduction payments must not be accelerated based on an employee's claims experience. For cafeteria plans with quarterly or similar salary reduction contribution intervals, the plan must return to participants any amount previously received for coverage relating to a period of time after a participant's termination date.

PERIOD OF COVERAGE

A cafeteria plan is permitted to have different periods of coverage for different benefits. The plan cannot enable a participant to purchase coverage for less than the coverage period. Employers who implement different coverage periods for different benefits (e.g. health care FSA, dependent care assistance, adoption assistance, or the cafeteria plan itself) must ensure that the written cafeteria plan accurately reflects the various coverage periods and that plan year amendments comply with section 125 and the regulations.

DISTRIBUTIONS FROM AN FSA TO AN HSA

The new proposed regulations incorporate the rules on qualified HSA distributions (rollovers) and clarify certain restrictions. An HSA distribution from a Health FSA to an HSA does not alter an

employee's irrevocable election or constitute a change in status. Thus, an employee covered by a general purpose FSA is not an "eligible individual" (as defined by 223(c)(1)) and therefore a mid-year distribution from a general purpose FSA (an FSA that is not terminated or converted to an HSA compatible FSA) into an HSA will result in adverse tax consequences.

If the cafeteria plan offers HSA contributions as a qualified benefit, the written plan must specifically describe the benefit, allow participants to prospectively change salary redirections for HSA contributions on a monthly basis or more frequently, and allow all participants who lose eligibility to make HSA contributions to revoke his/her election as it relates to HSA contributions.

FSA EXPERIENCE GAINS

The new proposed regulations clarify that the employer may retain experience gains (plan forfeitures), use forfeitures to defray administrative costs of the plan, or allocate forfeitures among employees in the immediately following plan year. The allocation must be reasonable and uniform; however, the new proposed regulations permit an employer provide a weighted allocation based on different coverage levels. In an example, the regulations also provide that the employer may reimburse claims incurred above the elective limit in the following year. These proposed regulations clarify two main points; first that the employer can retain the funds, and second that forfeiture amounts should be allocated in the immediately following year.

A Health FSA is an ERISA plan and thus subject to the exclusive benefit rule; therefore, although experience gains may be retained by the employer those funds must be used for the exclusive benefit of participants and beneficiaries.

1.125-6 SUBSTANTIATION OF EXPENSES FOR ALL CAFETERIA PLANS

DEPENDENT CARE

The new regulations provide guidance regarding reimbursement requirements of dependent care expenses and rules for terminated employees. The regulations permit reimbursement of dependent care expenses on or after the expenses are incurred. The new rules also add an optional spend-down provision for terminated employees participating in the dependent care FSA. This provision allows a plan to reimburse expenses incurred after an employee's termination date. If the plan provides this option, the written plan must have language permitting such reimbursements. Most plans already offer this option due to an administrative loophole created by the IRS rule that deems "actively seeking employment" as a "work related expense."

DEBIT CARDS

The new regulations incorporate previously issued debit card guidance. The employer must limit use of the card to merchants with medical care merchant category codes, drugstores and pharmacies with 90 percent of gross receipts of the prior year consisting of items which qualify as 213(d) medical expenses (90% rule), and stores that have implemented the inventory information approval system (IIAS). IIAS equates to point of sale substantiation. The system compares the stock keeping unit (SKU) to a list of items that qualify as 213(d) medical expenses. The system approves eligible expenses and denies non-eligible expenses thus eliminating the need for after purchase substantiation. The employer is responsible to ensure the IIAS and

recordkeeping requirements are satisfied. These regulations make clear the employers role in overseeing debit card administration.

The regulations also remind employers, brokers, and administrators that cafeteria plans with the debit card are currently functioning under transition relief. This relief permits debit card use at supermarkets, grocery stores, discount stores, and wholesale clubs until December 31, 2007.

After December 31, 2007, the debit card cannot be used at grocery stores, discount stores, and wholesale clubs unless the merchant has implemented IIAS. Similarly, after December 31, 2008, the debit card cannot be used at drugstores and pharmacies unless they satisfy the 90% rule or have implemented IIAS. Companies that currently have IIAS are Walgreens, Wal-Mart, and drugstore.com.

REIMBURSING DEPENDENT CARE THROUGH A DEBIT CARD

The new proposed regulations provide rules under which the debit card may be used to pay for dependent care expenses. Participants must first pay and substantiate the dependent care expense. The employer will then make available the previously substantiated and approved amount or the employee's total salary reduction amount to date. The employer may not make funds available before the services are provided. Few dependent care participants will benefit from the debit card because many dependent care providers require payment before the service is provided.

CORRECTING IMPROPER PAYMENTS

The new regulations confirm the hierarchical nature of debit card correction procedures. If a debit card is used for other than section 213(d) medical expenses, the employer must follow all of the following correction procedures. The employer must demand repayment and the debit card must be de-activated until the amount of the improper payment is received. If demand is unsuccessful, the employer may withhold the improper payment from the employee's compensation consistent with applicable law. If any amount remains outstanding, the employer can substitute or offset future claims against the improper payment. Lastly, if all other procedures fail, the employer, consistent with business practices, may treat the payment as any other business indebtedness.

This guidance clarifies three key points. First, the IRS explicitly provided a step-by-step process (e.g. employers should not employ wage withholding until after demand for payment is unsuccessful). Second, claims substitution can be automatically applied against future claims. And third, employers must ensure that withholding payments from compensation is consistent with state wage withholding law and other applicable law.

§1.125-7 CAFETERIA PLAN NONDISCRIMINATION RULES

DEFINITIONS

The new regulations define officer, highly compensated individual or participant, five percent shareholder, key employee, and compensation. Section 125 and the regulations had not previously provided a definition of officer; however, most employers and administrators borrowed the definition of officer from section 416 regulations relating to Pension Plans. The

new definition of officer essentially mirrors the section 416 definition; therefore, the new definition makes little impact on plan testing.

ELIGIBILITY TEST

The new rules excluded certain employees from consideration for purposes of the safe harbor percentage test and the unsafe harbor percentage component of the facts and circumstances test. Those employees excluded from consideration include: employees covered by a collectively bargained plan; employees who are nonresident aliens receiving no earned income from the employer constituting income from United States sources; and COBRA participants. Additionally, if the cafeteria plan provides a three year waiting period the plan is permitted to exclude from consideration employees who have not completed three years of employment. Note that most plans do not impose a three year waiting period.

CONTRIBUTIONS AND BENEFITS

The new regulations provide an objective test to determine when actual election is discriminatory. The new test asks whether the plan gives similarly situated participants a uniform opportunity to elect qualified benefits and whether highly compensated participants actually disproportionately elect qualified benefits. The regulations further explain when qualified benefits are "disproportionately elected."

PERMISSIVE DISAGGREGATION

If the plan does not impose a three year eligibility waiting period, the regulations permit a plan to test as if it were two separate plans. The first plan would consist of employees who have completed one day of employment but less than three years and the other plan would consist of employees completing three or more years of employment. This rule permits a plan to test eligibility and contributions and benefits as two separate plans but does not permit separate testing for the key employee concentration test.

OPTIONAL AGGREGATION

If an employer has more than one plan, the eligibility and the contributions and benefits test can be tested as a whole. The employer cannot aggregate if the principle purpose is to manipulate nondiscrimination testing or discriminate in favor of highly compensated participants.

TIME TO PERFORM NONDISCRIMINATION TESTING

Nondiscrimination testing must be performed as of the last day of the plan year. This rule requires that plans conduct nondiscrimination testing based on data of the entire year. The test must consider all nonexcludable employees and former employees. Former employees include terminated employees, retired individuals, and those who have otherwise terminated participation in the cafeteria plan.

SUMMARY

The new proposed regulations clarify IRS expectations and impose new written cafeteria plan requirements. Employers, advisors, and administrators will need to review written plans to ensure compliance by January 1, 2009. Keep in mind that the new proposed regulations incorporate past guidance and that most cafeteria plans already comply with the new written plan requirements.

The information contained herein is not intended as legal advice and may not be relied upon as legal advice. If you need legal advice upon which you may rely you must seek the advice of your attorney. This information is general information about the law and does not include advice regarding the application of law to specific situations.