

Special point of interest:

- **IRS ISSUES NEW PROPOSED REGULATIONS ON CAFETERIA PLANS**

Monthly Newsletter

IRS Issues New Proposed Regulations On Cafeteria Plans

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[Prop. Treas. Reg. Secs. 1.125-1, 1.125-2, 1.125-5, 1.125-6, and 1.125-7, 72 Fed. Reg. 43937 (Aug. 6, 2007)] For a copy: <http://edocket.access.gpo.gov/2007/pdf/E7-14827.pdf>

New proposed IRS regulations on cafeteria plans are here at last! They replace older proposed regulations and incorporate prior IRS guidance--items that, in some cases, were issued more than 20 years ago. The regulations address cafeteria plans, health FSAs, DCAPs, and other benefits. While many requirements remain substantially the same, there are also numerous changes and clarifications to existing rules.

The regulations also incorporate tax-law changes made in the last few years (e.g., reflecting the new definition of dependent and the addition of HSAs as qualified benefits). We can't possibly list all of the differences between the old and the new regulations, but here are some highlights:

==> General Rules. The list of items required to be in the written cafeteria plan document has been expanded; the regulations also provide that if there is no written plan document, if the document doesn't meet regulatory requirements, or if the plan isn't operated in accordance with its terms, then the plan is not a cafeteria plan, resulting in taxable income to employees. The regulations clarify that plan year changes and short plan years are permitted only for valid business purposes, and that self-employed individuals and more-than-2% shareholders of Subchapter S corporations can't participate in cafeteria plans. In addition, the regulations address payment of COBRA premiums through a cafeteria plan. Further, the regulations emphasize that a Code Section 125 cafeteria plan generally is the exclusive means by which employees can be given a

choice between taxable and nontaxable benefits without the choice resulting in taxable income.

==> Benefits. Cafeteria plans are expressly allowed to pay or reimburse employees' individual health insurance premiums upon receipt of appropriate substantiation. (No mention is made of reimbursing policies in a spouse's or dependent's name.) Vision or dental insurance coverage with a "two-year lock-in" can be offered under a cafeteria plan without violating the no-deferred-compensation rule, so long as premiums for each plan year are paid at least annually, and salary reductions and flex credits relating to the first year aren't applied toward coverage for the second year. Moreover, salary reductions from the last month of a cafeteria plan year can be used to pay accident and health coverage premiums for the first month of the next plan year. Salary reductions can also be used to pay "reasonable cafeteria plan administrative fees." The taxation of group term life (GTL) insurance coverage in excess of \$50,000 is also addressed--under the regulations, employee salary reductions for the excess coverage aren't taken into account when determining the amount to include in an employee's taxable income for the excess coverage.

==> Elections. One particularly significant change is that cafeteria plans may give new employees 30 days to make a cafeteria plan election effective as of the employee's hire date (salary reductions must come from compensation that isn't "currently available" when the election is made). However, this provision doesn't apply to terminated employees who are rehired within 30 days (or who take an unpaid leave of absence for less than 30 days). The regulations also allow "default elections" for qualified benefits for new or current employees who fail to make timely elections (e.g., a previous year's election could be deemed to continue unless changed), if certain procedures are followed.

In addition, elections and election changes can be made electronically; the "safe harbor" provisions of other IRS regulations regarding use of electronic media for benefit-related notices, elections, and consents are available for this purpose. The regulations emphasize that only employees (not spouses or dependents) can make, change, or revoke cafeteria plan elections. Election rules for salary reduction contributions to HSAs are also addressed, indicating among other things that participants must be allowed to change such elections at least monthly.

==> FSAs. Consistent with prior informal guidance, the regulations confirm that health FSAs may, but aren't required to, reimburse advance payments for orthodontia services without violating the no-deferred-compensation rule, so long as the employee has actually made the advance payments in order to receive the services. Medical equipment with a useful life extending beyond the period of coverage in which the expense is incurred (e.g., a wheelchair) can also be reimbursed without violating this rule. The regulations provide that cafeteria plans may limit health FSA enrollment to employees who also participate in one or more of the employer's accident and health plans. In addition, a cafeteria plan may include a "spend-down" provision allowing employees who ceased participation (e.g., because of termination) to be reimbursed from unused DCAP benefits for eligible dependent care expenses incurred during the remainder of the plan year. Guidance is also provided on adoption assistance offered through a cafeteria plan; in general, rules similar to those for DCAPs apply.

==> Substantiation. Health FSAs with electronic payment card programs must provide that cards are automatically canceled when employees cease to participate in the health FSA. (Under card programs approved in prior guidance, cards were canceled at termination of employment; the new proposed regulations appear to allow card use by COBRA qualified beneficiaries.) The regulations also clarify that employers are responsible for ensuring that any inventory information approval system (IIAS) used under their card programs complies with applicable substantiation, reimbursement, and recordkeeping requirements. And in addition to meeting general substantiation requirements, participants in post-deductible health FSAs must provide independent third-party substantiation that the HDHP deductible has been satisfied; participants in limited-purpose health FSAs must provide independent third-party substantiation that the expenses are for dental, vision, or preventive care.

==> Nondiscrimination Rules. Additional guidance is provided on the cafeteria plan nondiscrimination rules. For example, more detail is provided regarding the definitions of highly compensated individual and key employee; a safe harbor is also established for premium-only cafeteria plans. Testing must be performed as of the last day of the plan year but must take into account all non-excludable

employees (and former employees) who were employed on any day during the plan year.

==> Effective Date; Status of Older Proposed Regulations. **In general, the regulations are proposed to apply for plan years beginning on or after January 1, 2009.** However, there are a few exceptions. For example, the provisions regarding taxation of GTL insurance in excess of \$50,000 are effective now. Also, the effective dates for previously issued guidance on electronic payment cards remain in force. Older proposed cafeteria plan regulations (e.g., those issued in 1984) have been withdrawn; temporary regulations addressing what benefits may be offered under a cafeteria plan were recently removed. Meanwhile, taxpayers may rely on the new proposed regulations for guidance until final regulations are issued.

EBIA Comment: Employers and administrators have eagerly anticipated these regulations, which gather years of formal and informal guidance in one place and provide much-needed certainty on various issues.

Fortunately, most of the changes are favorable; the regulations also include many helpful examples. However, some items on our wish list were missing--for example, the nondiscrimination provisions were lacking the comprehensive guidance that we hoped for. The regulations also raise a number of other questions (e.g., why was only orthodontia (and not prenatal programs or infertility treatment) excepted from the no-deferred-compensation rule?). The IRS has requested comments on three topics that perhaps will be addressed when the regulations are finalized: determining the "uniform coverage amount" after a mid-year election change, whether multiple employers (other than controlled group members) may sponsor a single cafeteria plan, and whether salary reductions can be taken from employees' tips. For now, those who work with cafeteria plans must begin to familiarize themselves with the regulations--a time-consuming process, even for veterans. Keep in mind that the IRS rules shouldn't be viewed in a vacuum--other legal requirements must also be considered (e.g., HIPAA raises concerns for individual medical policies).

BAS will provide you with additional information on this topic in future Newsletters. Specific questions should be referred to the BAS Flexible Spending Department at 708-799-7400.