IRS Dishes Out New Cafeteria Plan Regulations

On August 6, 2007, the Internal Revenue Service (IRS) withdrew all existing proposed and temporary regulations on cafeteria plans under Section 125 of the Internal Revenue Code (the Code), replacing them with five new proposed regulations. The new regulations, which would become effective in plan years beginning after 2008 if adopted as proposed, give the following guidance to employers. The regulations:

• Validate a number of practices that employers adopted over the years in response to established cafeteria plan rules;

• Expand guidance on certain existing cafeteria plan rules; and

• Introduce new rules that govern the design and operation of cafeteria plans.

The new rules do not significantly alter the existing legal landscape for employers that sponsor cafeteria plans. The IRS proposed its first set of cafeteria plan regulations more than 20 years ago and, over the years, supplemented those regulations with numerous rulings and notices. Generally, the new proposed regulations consolidate that guidance.

What’s New on the Menu?
The primary changes in the new regulations are as follows:

• More explicit guidance on the requirement that employers must maintain a written cafeteria plan document;

• Rules on annual nondiscrimination testing for cafeteria plans;

• An immediate change in the method of imputing income for group life insurance coverage in excess of $50,000;

• Authorization of the payment of COBRA and individual health insurance premiums on a pretax basis through a cafeteria plan; and

• Authorization of electronic enrollment into cafeteria plans.

What Stayed the Same?
The new regulations have been updated for a number of legislative and regulatory changes that the IRS issued over the last few years, including legislation and guidance on: 1) health savings accounts (HSAs); 2) the definition of “dependent” for federal income tax purposes; and 3) debit cards used in connection with flexible spending arrangements (FSAs).
Implications for Cafeteria Plan Sponsors
Employers that sponsor cafeteria plans should examine their plans to ensure they comply with the new regulations. Specifically, plan sponsors should perform the following checks to ensure that they are in compliance with the proposed regulations:

- Review and, if necessary, redraft their plan documents to ensure they contain the necessary provisions to maintain the qualification of the cafeteria plan;

- Conduct the appropriate nondiscrimination tests on an annual basis;

- Review their imputed income methodologies for cafeteria plan benefits;

- Review debit card administrative practices and inventory information approval system procedures; and

- Consider design enhancements allowable under the new rules such as electronic enrollment, automatic enrollment, a spend-down for their dependent care assistance plan, and updates to substantiation requirements of their health FSA with respect to the new orthodontia rules.

Detailed List of Changes
The new rules consist of five separate regulations, as follows.

Qualified and Nonqualified Benefits in Cafeteria Plans (Proposed Treasury Regulation Section 1.125-1)
The new regulations confirm that a cafeteria plan is the exclusive means by which an employer can offer employees a choice between taxable and nontaxable benefits without resulting in the employees having to recognize income. In addition, the regulations provide guidance on a host of issues.

The regulations:

- Expand the written plan requirements for a cafeteria plan;

- Confirm the adverse tax ramifications for noncompliance with the cafeteria plan rules;

- Clarify who can participate in a cafeteria plan;

- Clarify what is a permitted taxable benefit by defining what is “cash” to include paid time off and severance pay and specifically excluding distributions from retirement plans;

- Expand on what qualified benefits may be offered under a cafeteria plan to include HSAs, adoption assistance, COBRA premiums, individually obtained health insurance, and postretirement life insurance premiums for employees of certain educational institutions;

- Confirm the definition of “plan year”;

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• Clarify the prohibition that qualified benefits cannot defer income by creating exceptions for certain benefits that relate to more than one year, such as disability insurance benefits that span more than one year, the allowance of a two-year lock-in rate for vision and dental, and premium waiver during disability;

• Provide a new rule for the method for imputing income for group term life insurance in excess of $50,000 by providing that employees must include the Table I cost of coverage in excess of $50,000 minus any after-tax contributions, discarding the old “greater of” rule;

• Provide a new rule for the use of pretax contributions to pay for health coverage for individuals who are not a participant’s tax dependents if they receive imputed income for the full fair market value of coverage;

• Confirm the ordering rules for paid time off by confirming that nonelective time off must be used before elective time off and that all unused elective time must be cashed out or forfeited at the end of the year;

• Confirm the rules for offering an FSA grace period;

• Expand the rules regarding after-tax contributions to a cafeteria plan to allow cafeteria plans to accept after-tax contributions and paid time off as payment for qualified benefits;

• Provide a new rule on the use of pretax contributions in one year to pay health insurance premiums for the first month of coverage in the following year; and

• Provide a new rule for imposing reasonable participant fees which can be paid on a pretax basis.

**Elections in Cafeteria Plans (Proposed Treasury Regulation Section 1.125-2)**

Participants in a cafeteria plan must be permitted to make an election between permitted taxable benefits and qualified benefits. That election must be prospective and irrevocable for the entire plan year. In addition, the new regulations clarify that the participant alone is allowed to make an election under a cafeteria plan, and that their spouse or dependents cannot make, revoke, or change elections. This section covers only the general rules on participant elections; it does not cover the change in election rules which are governed by Final Treasury Regulations Section 1.125-4 (the change in status rules), which are not affected by the new regulations.

The new rules also:

• Provide a new rule authorizing of the use of electronic elections, revocations, and changes in election;

• Provide a new rule authorizing automatic elections (negative or default elections);

• Confirm the rules governing changes in elections for HSAs; and

• Provide a new rule authorizing the use of a 30-day retroactive enrollment period for new hires.
FSAs in Cafeteria Plans (Proposed Treasury Regulation Section 1.125-5)
This regulation confirms an FSA as a benefit designed to reimburse employees for expenses for dependent care assistance, adoption assistance, and medical care. The new regulations confirm that the use-it-or-lose-it rule still applies and that the period of coverage for FSAs continues to be 12 months, with the exception of short plan years. In addition, the new rules reaffirm that the uniform coverage rule continues to apply to health FSAs, but does not apply to dependent care or adoption assistance plans.

The new regulations also:

• Clarify that employee contributions of employer-provided flex credits can be made to an FSA;
• Provide a new rule authorizing a reasonable minimum threshold (e.g., $50) for FSA reimbursements;
• Confirm that different FSAs under the same cafeteria plan can have separate periods of coverage;
• Provide a new rule allowing employers to limit health FSA enrollment to those employees who elect group health coverage through the cafeteria plan;
• Confirm an employer’s ability to specify any uniform interval for salary contributions;
• Confirm that an employer may limit reimbursements under a health FSA to only certain permitted medical expenses allowable under Section 213(d) of the Code;
• Confirm that health FSAs may reimburse advance payments for orthodontia and durable medical equipment;
• Confirm the prohibition against health FSAs reimbursing health insurance premiums;
• Confirm the requirement that health FSAs comply with the nondiscrimination requirements that apply to self-funded health plans;
• Confirm the rules governing HSA-compatible FSAs;
• Clarify the substantiation requirements for post-deductible health FSAs;
• Confirm the rules governing qualified HSA distributions; and
• Provide new rules for the use and allocation of FSA experience gains and confirm that an employer may retain experience gains to offset administrative costs, including costs associated with overspent accounts.
Expense Substantiation Requirements for Qualified Benefits Offered in a Cafeteria Plan (Proposed Treasury Regulation Section 1.125-6)
Under a cafeteria plan, an independent third party must substantiate all claims before any reimbursements for a qualified benefit can be made. The new rules also confirm that reimbursements can only be made for qualified expenses that are incurred during the period of coverage. In addition, the IRS confirms the rules for using a debit card in connection with an FSA.

The new regulations also:

- Confirm when an expense is considered “incurred” for FSA purposes;
- Provide a new rule authorizing a spend-down provision for dependent care assistance plans to allow participants who terminate during the plan year to spend the remainder of their account balance down;
- Confirm the use of direct data feeds of explanation of benefits (EOBs) from an insurance carrier to substantiate health FSA expenses without further documentation or review;
- Confirm that the debit card used in connection with a health FSA can only be used at merchants that have health-related merchant category codes; drug stores that can show at least 90% of their revenue comes from sales for medical care; or merchants that have an inventory information approval system;
- Confirm the corrective measures a health FSA must take when a participant has used the card for an impermissible expense;
- Confirm that the only debit card transactions that do not require further review or documentation are copayments, recurring expenses, and claims that are substantiated real-time;
- Confirm that, if employers allow point-of-sale substantiation through an inventory information approval system, they are responsible for ensuring the system complies with the regulations;
- Confirm the rules for substantiating multiple copayments in a single transaction; and
- Confirm the rules for using a debit card in connection with a dependent care assistance plan.

Nondiscrimination Testing Rules for Cafeteria Plans (Proposed Treasury Regulation Section 1.125-7)
In the past, employers have been uncertain as to the proper method for conducting many of the nondiscrimination tests for cafeteria plans. The new proposed regulations provide much needed guidance on the nondiscrimination rules that apply to cafeteria plans by:

- Providing definitions of key terms;
- Providing guidance on conducting the eligibility test and the contributions and benefits tests;
• Providing descriptions of employees who can be excluded from testing and a safe harbor nondiscrimination test for cafeteria plans;

• Clarifying the eligibility test by incorporating the coverage rules of Section 410(b) of the Code (reasonable classification, safe harbor, and unsafe harbor percentage tests);

• Clarifying the contributions and benefits test by offering an objective test to determine whether the actual election of benefits is discriminatory; and

• Providing 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.

The new proposed regulations do not alter or affect the final regulations that apply to cafeteria plans regarding the impact of the Family and Medical Leave Act on the operation of a cafeteria plan or the final rules on permitted election changes.

Effective Date
With certain exceptions, the new proposed regulations apply for plan years beginning on or after January 1, 2009. However, employers may rely on the new rules immediately.

More Information
If you have questions about the new cafeteria plan regulations, please contact your local Hewitt Consultant.