

EMPLOYEE BENEFITS CLIENT ALERT

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IRS Releases New Proposed Cafeteria Plan Regulations

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New proposed cafeteria plan regulations were released on August 6, 2007 that replace prior proposed and temporary regulations, which are withdrawn, and consolidate law changes and guidance issued by the IRS over the past twenty years. The regulations preserve much of the existing guidance but clarify some outstanding issues and include a few new rules. Existing cafeteria plan regulations governing mid-year election changes and FMLA operations remain the same. This alert highlights some of the more notable new or clarifying provisions of the proposed regulations.

Who this Affects Employers with existing cafeteria plans. This also affects employers without a cafeteria plan who offer cash in lieu of non-taxable benefits, and employers without plans in states mandating establishment of cafeteria plans to allow employees to pay for coverage under individual health policies or state-mandated arrangements on a pretax basis. Massachusetts currently has such a law and other states are following suit. Similar legislation has been proposed in Pennsylvania.

Effective Date In general, the regulations are proposed to be effective for plan years beginning on and after January 1, 2009, but may be relied on in the interim until final regulations are issued. A new rule for determining the taxable amount of group term life insurance in excess of \$50,000 is effective immediately. Effective dates of previously issued debit card guidance remain the same. The IRS is accepting comments from the public until November 5 and will hold a hearing on the regulations on November 15, 2007. After this process, the IRS will issue regulations in final form.

Action Steps Employers with existing cafeteria plans should begin reviewing their plans against the regulations to determine whether compliance changes will be required if the regulations are finalized in their present form, and to determine if there are any optional provisions they wish to implement. Employers without cafeteria plans that are mandated by state law to establish a plan will need to become familiar with and comply with the rules. **Special Note:** The IRS reiterated that a cafeteria plan is the exclusive means of allowing an employee to elect between taxable and nontaxable benefits on a tax effective basis. Such an election includes, for example, the common practice of offering cash in lieu of health coverage. If this election is provided outside of a cafeteria plan, the employee will have taxable income equal to the largest available taxable benefit. Employers who have been providing this election outside of a cafeteria plan should carefully review this with counsel.

Regulation Highlights

Required, Permitted and Prohibited Benefits The regulations clarify that a cafeteria plan must offer a choice between at least one permitted taxable benefit and at least one permitted nontaxable benefit. Permitted taxable benefits are cash and certain other taxable benefits treated as cash. Cash includes cash compensation, payments for annual leave, sick leave or other paid time off and severance pay but does not include distributions from qualified retirement plans.

Qualified Benefits. The regulations consolidate all prior guidance on permitted nontaxable ("qualified") benefits that may be offered under a cafeteria plan. They include the following: accident and health plans (including health FSAs); group term life insurance providing no permanent benefits; dependent care;

accidental death and dismemberment benefits; long and short term disability benefits; elective deferrals to a 401(k) plan (but not a 403(b) arrangement); HSA contributions; adoption assistance; and contributions for certain post-retirement group life insurance plans maintained by educational organizations. In addition, the proposed regulations also expressly permit the following benefit offerings:

- **COBRA Premiums.** Cafeteria plans may allow employees to pay COBRA premiums for coverage under the employer's own health plan (on a pretax basis if the coverage is tax free to the employee, otherwise after-tax). Plans may also permit an employee to pay for COBRA premiums for coverage under another employer's health plan but only if the COBRA coverage is otherwise tax-free to the employee. The expenses must be substantiated and reimbursed to the employee in accordance with certain conditions. Premiums may not be paid from a Health FSA.
- **Individual Policy Premiums.** Cafeteria plans may allow employees to pay for individual health insurance policy premiums for the employee on a pretax basis. The expenses must be substantiated and reimbursed to the employee in accordance with certain conditions. The premiums may not be paid from a Health FSA.
- **Health Coverage for Non-Dependents.** Employees may elect employer-provided health coverage as a taxable benefit for a non-dependent (such as a domestic partner) provided that the fair market value of the coverage is included in the employee's income.

Prohibited Benefits. The following benefits are considered nonqualified and may not be offered under a cafeteria plan, even on an after-tax basis: scholarships; educational assistance; fringe benefits under Code Section 132; employer-provided meals and lodging; group term life insurance on the life of any person other than the employee; contributions to Archer Medical Savings Accounts (MSAs); contributions to a Health Reimbursement Arrangement (HRAs); contributions to a 403(b) arrangement; or long-term care insurance or services. Although long-term care insurance or services may not be offered directly as a benefit under a cafeteria plan, the regulations allow long-term care services and long-term care insurance to be paid from a Health Savings Account (HSA) funded through a cafeteria plan.

- **Failure to Certify Other Health Coverage.** The regulations contain an example of a common practice where employees must buy health coverage unless they show proof of other coverage. The regulations say that contributions used to purchase employer-provided health coverage under Code Section 125 are not includible in income if the employee can elect cash; and go on to say that Section 125 does not apply to the coverage of employees who can't certify other coverage since they don't have the ability to elect cash. This suggests that requiring an employee to buy coverage (pretax or otherwise) for failure to certify other health coverage can jeopardize the otherwise tax-free nature of the health coverage.

Group Term Life Insurance The proposed regulations change and modify existing guidance provided in Notice 89-10 regarding the calculation of imputed income for group term life insurance in excess of \$50,000. The employee is now taxed on the Table I rate (minus after tax employee contributions, if any) and salary reductions are not taken into consideration. The proposed regulations provide examples of the new calculation.

Written Plan Document Content Rules The regulations clarify that a cafeteria plan must be in writing and include certain provisions. The document must reflect eligibility rules and election procedures, must provide that all elections are irrevocable unless the plan includes permitted change in election rules, reflect the plan year, specify how employer contributions may be made under the plan (such as salary reduction or nonelective employer contributions) and the maximum amount of elective contributions; and describe all benefits offered through the cafeteria plan (which may be satisfied by incorporating by reference separate plans that describe the benefits). If offered, the document must also describe the rules applicable to health and dependent care FSAs (such as use-it-or-lose-it) and the uniform coverage rule for health FSAs along with the optional 2½ month grace periods, if used. And, if offered, the plan must reflect the ordering rule for use of paid time off. Finally, the plan must specify that participation is limited to employees.

Employees Eligible to Participate "Employees" include common law employees, and certain leased employees and certain full-time life insurance salesmen. Former employees, including employees who are laid off and retirees may participate as long as the plan is not maintained predominantly for them. Self-employed individuals may not participate. Sole proprietors, partners, directors, and 2-percent shareholders of S corporations are not considered employees and may not participate. However, a sole proprietor may sponsor a cafeteria plan covering the sole proprietor's employees (but not the sole proprietor). Similarly, a partnership or S corporation may sponsor a cafeteria plan covering employees (but not a partner or 2-percent shareholder of an S corporation). New rules apply to "dual status" individuals (such as an employee who is also director of the company). For example, an individual who is both an employee and a director can participate as an employee to the extent of his employee compensation. The dual status rules do not apply to partners and more than 2% shareholders of S Corporations.

Elections Notable provisions affecting elections include the following:

- **Automatic Elections.** Automatic elections (default/evergreen) are expressly permitted.
- **Initial Elections for New Hires.** Employees may make elections within 30 days after their hire date with coverage retroactive to the date of hire although salary reductions may only be taken from compensation that is not yet *currently available* in accordance with the proposed rules. This rule does not apply to any employee who terminates employment and is rehired within 30 days (or who returns to employment following an unpaid leave of absence of less than 30 days) and the plan must so specify.
- **Two-Year Dental and Vision Election Lock.** Cafeteria plans may permit offerings of dental and vision plans that require two-year election locks (as an exception from the prohibition on deferral of compensation) provided that the premiums are paid no less than frequently than annually and salary reductions from one year are not used to pay premiums for the subsequent year.
- **Electronic Elections.** Electronic elections are specifically authorized. A safe harbor under other IRS regulations applies for purposes of cafeteria plan electronic elections, revocations and changes in election.

Dependent Care New Dependent Care features include:

- **Spend Down Feature.** Cafeteria plans may now allow reimbursement of expenses incurred after termination of an employee's participation through the end of the Plan Year (or the end of the 2½ month grace period for plans adopting the grace period) if the rule is specified in the plan document.
- **Debit Cards.** The regulations authorize and provide rules for paying dependent care expenses by debit card.

Health FSA Expenses

- **Advance Orthodontia Payments.** Cafeteria plans may (but are not required) to reimburse employees for orthodontia services paid in advance before the services are incurred but only to the extent that the employee has actually made the advance payments and is required to make the advance payments in order to receive the services. These orthodontia services are deemed to be incurred when the employee makes the advance payment.

Health Savings Accounts

- **Election Changes.** Cafeteria plans offering HSAs are required to permit participants to change their salary reduction amounts prospectively on at least a monthly basis and must permit an ineligible participant to revoke his election prospectively.
- **Non-Discrimination Rules.** Notably, the regulations specify that employer contributions made to an HSA through a cafeteria plan are subject to cafeteria plan non-discrimination rules rather than the otherwise applicable comparability rules of Code section 4980G.

HSA/Health FSA Interaction A general purpose Health FSA will disqualify the individual from having an HSA so “limited purpose” Health FSAs and “post-deductible” Health FSAs are expressly authorized. The regulations also include recent guidance on the limited circumstances allowing transfers from Health FSAs to HSAs.

Limited Salary Reduction Rollover Salary reductions from the last day of the Plan Year may be used to pay health coverage premiums for the first month of the following Plan Year.

Guidance on Nondiscrimination Rules New guidance is provided on cafeteria plan nondiscrimination rules. Definitions of key terms (including highly compensated individual or participant, officer, five percent shareholder, key employee and compensation) are provided as well as guidance for testing for nondiscrimination in eligibility (incorporating some Code section 410(b) rules) and guidance for testing nondiscrimination in contributions and benefits. Finally, the new rules provide guidance on the safe harbor for cafeteria plans providing health benefits and institute a safe harbor for premium-only plans that satisfy certain requirements.



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