

Route to: \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

If you would like to receive other free  
Thompson *HR Special Reports*, please visit  
us at [www.thompson.com/HRreports](http://www.thompson.com/HRreports)

---

# The New Proposed Cafeteria Plan Rules: Essential Facts and Insights

---

## Special Report

---

*Cafeteria plan sponsors and third-party administrators will need to change some of their procedures starting in 2009. Here's a look at what's new and what stays the same.*

 **THOMPSON**

Insight you trust.



## Thompson Publishing Group, Inc.

Thompson Publishing Group is a trusted name in providing professionals with authoritative analysis of laws and regulations that help businesses develop regulatory compliance strategies. Since 1972, thousands of professionals in business, government, law and academia have relied on Thompson Publishing Group for the most authoritative, timely and practical guidance available.

Thompson offers loose-leaf services, books, specialty newsletters, audio conferences and online products in a number of subject and regulatory compliance areas. We offer 30 products featuring analysis, practical guidance and real-world solutions to issues facing human resource professionals, written by our network of experts. For more information, visit us at [thompson.com](http://thompson.com).

*The New Proposed Cafeteria Plan Rules: Essential Facts and Insights* is published by Thompson Publishing Group, Inc., 1725 K St. NW, 7th Floor, Washington, DC 20006.

Authors: Terry Humo and Paul Hamburger

Editor: Joe Lustig

Desktop Publisher: Brock G. McClung



This information is designed to be accurate and authoritative, but the publisher is not rendering legal, accounting or other professional services. If legal or other expert advice is desired, retain the services of an appropriate professional.

Copyright ©2007 by Thompson Publishing Group, Inc. All rights reserved.

Photocopying without the publisher's consent is strictly prohibited. Consent needs to be granted to reproduce individual items for personal or internal use by the Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923.

---

# The New Proposed Cafeteria Plan Rules: Essential Facts and Insights

---

*By Terry Humo and Paul Hamburger*

The administration of Section 125 plans will be significantly affected by new proposed cafeteria plan rules issued Aug. 6, 2007 by the IRS. The new rules, which apply to a variety of benefits that cafeteria plans can offer, will require changes to some current administrative practices.

Cafeteria plan sponsors, participants and third-party administrators may rely on the rules for guidance immediately while the IRS finalizes them. The IRS is accepting public comment through Nov. 5, 2007 and will hold a hearing on the rules on Nov. 15, 2007.

As proposed, the general cafeteria plan rules will become final for plan years beginning on or after Jan. 1, 2009. There is an exception for immediate application of new treatment for contributions to group term life benefits in a cafeteria plan (Treas. Reg. §1.125-1(s)). Also, effective dates for recently incorporated guidance on debit cards remain applicable (Treas. Reg. §1.125-6(h)).

This special report provides essential facts and insights on the new proposed rules, including a section-by-section analysis of the most significant rules and their impact. It draws on the insights of Thompson Publishing Group authors Terry Humo and Paul Hamburger, attorneys and advisors on employee benefit issues.

## Introduction

The proposed rules reflect changes in tax law since 1984, including the addition of health savings accounts (HSAs) and other qualified benefits cafeteria plan sponsors may offer. On publishing the rules, the IRS also announced the withdrawal of notices of proposed rulemaking relating to Section 125 plans that published in 1984, 1989, 1997 and 2000. Separately, the IRS also withdrew temporary Section 125 regulations that were published on Feb. 4, 1986.

### Accessing the Rules

View the full text of the rules at  
<http://www.thompson.com/images/thompson/reports/2007proposed-rule-cafeteria-plans.pdf>.

**[CLICK HERE](#)**

*Terry Humo, a benefits consulting attorney in Missoula, Mont., is the co-author of the Guide to Consumer-Directed Health Care, and the author of the Employer's Guide to Self-Insuring Health Benefits and the Employer's Guide to the Health Insurance Portability and Accountability Act, all published by Thompson Publishing Group.*

*Paul Hamburger, P.C., a partner in the Washington, D.C. office of the law firm McDermott, Will & Emery LLP, is the author of Mandated Health Benefits: the COBRA Guide, the Pension Plan Fix-it Handbook and the Guide to Assigning & Loaning Benefit Plan Money, all published by Thompson Publishing Group.*

The proposed rules bring nondiscrimination testing up to date. Nondiscrimination tests must be performed annually before the end of each plan year. The nondiscrimination rules also introduce a safe harbor for health premium only plans (POPs) as well as safe harbors for other health and cafeteria plans generally. Also, the provisions introduce an objective benefits discrimination test.

In addition, COBRA coverage for former as well as current employers can be paid for on a pre-tax basis through current employer salary reductions. (See the last section of the report for more analysis of the rules' effect on COBRA administration.)

While the proposed rules largely represent consolidation of old proposed rules and subsequent specific-issue rulings, clarifications and nuances touch common employer practices with potentially costly ramifications along with time- and money-saving possibilities.

For example, employers may use excess contributions to health flexible spending arrangements (FSAs) under the proposed forfeiture rules, but also risk running afoul of Department of Labor (DOL) fiduciary and plan asset rules. Employers may mandate participation in health plans, as well, but in doing so risk losing cafeteria plan status, which in turn could trigger DOL trust and reporting requirements.

On the other hand, the proposed rules' confirmation of using premium reimbursement plans in the cafeteria plan context may offer employers options for extending health coverage to current nonparticipating employees.

Employers should review carefully with third-party service providers and legal counsel the new proposed cafeteria plan rules. The material below highlights some key provisions from the rules.

Note that the rules do not address the IRS' 2001 change-in-status rules issued under Treas. Reg. §1.125-4, except to the degree a cafeteria plan sponsor may choose to incorporate those provisions into its written cafeteria plan.

Other notable provisions of the new proposed rules include:

- Individuals may pay for COBRA premiums for coverage under the current or a former employer's plan on a salary-reduction basis (Treas. Reg. §1.125-1(3)(b)).
- Individuals may be given the choice to receive severance pay or use the money to pay COBRA premiums (Treas. Reg. §1.125-1(a)(2)).
- If an employer provides a choice between flex credits (employer contributions) and a qualified benefit (excludable from gross income) with any unused flex credits unavailable as cash or other non-taxable benefit, the plan is not a cafeteria plan (Treas. Reg. 1.125-5(b)).
- Under prohibitions on deferred compensation, a plan may not provide for retiree health benefits for current employees beyond the current plan year (Treas. Reg. §1.125-1(o)).
- Two-year lock-ins of premiums/coverage for dental and vision do not violate the deferred compensation prohibition, nor do carry-forward of credits against deductibles, progressive payments for diagnosed conditions, or payment through salary reduction in the last month of a plan year to pay for coverage for the first month under the succeeding plan year (Treas. Reg. §1.125-1(p)).
- Plans are limited to 12 consecutive month plan years that may run from any date (such as June 1 to the following May 31). The plan year must be specified in the written plan document. The limited exceptions for short plan years for legitimate business reasons and grace periods are retained, however (Treas. Reg. §1.125-1(d)(e)).

- Contributions to HSAs but not to Archer medical savings accounts (MSAs) are excepted from the general rule prohibiting deferred compensation (Treas. Reg. §1.125-1(a)(3)), (Treas. Reg. §1.125-1(q)).
- Reasonable premium rebates or policy dividends paid on cafeteria plan benefits are not prohibited deferred compensation if paid within 12 months of the cafeteria plan year to which the rebates and dividends relate (Treas. Reg. §1.125-1(p)(3)).
- Employees may elect health coverage for non-spouses or non-dependents as a taxable benefit (Treas. Reg. §1.125-1(h)(3)). The rule may be directed to domestic partners, but also would appear to include other family members such as nondependent grandchildren, for example.

## Overview of Cafeteria Plans

As defined in the proposed rules, cafeteria plans allow employers to offer one or more benefits on a tax-favored basis. To qualify, the cafeteria plan must offer at least one taxable benefit (such as cash) and at least one benefit that is excludable from income (such as health coverage) with employee contributions made typically on a salary-reduction basis (Treas. Reg. §1.125-1). The cafeteria plan in its simplest form is the POP. The employee may elect salary at the regular level (cash) or health coverage, which is excludable from gross income and paid with salary, reduced pre-tax, to pay the employee share of the cost (Treas. Reg. §1.125-1(a)(5)).

### *Choice of cash or excludable benefit*

The essence of the cafeteria plan is an individual's choice between cash and excludable benefits. Thus, as laid out in the new proposed rule, mandating employee participation in a POP, for example, disqualifies the POP as cafeteria plan.

**Example.** An employer mandates employees who have no other health coverage to enroll in single coverage under the cafeteria plan on a salary-reduced basis. The plan also provides the option to buy up into family coverage also on a salary-reduced basis. This is not a cafeteria plan as to the single coverage (Treas. Reg. §1.125-1(b)(3)).

Although the individual may still be able to get the health coverage and reimbursements on a tax-favored basis under Code Sections 105 and 106, other possible ramifications exist for the plans. For example, DOL trust and reporting rules exempt cafeteria plans from their requirements. Loss of cafeteria plan status, therefore, could also trigger those requirements.

## Premium Reimbursement Plans

Under the proposed rules, cafeteria plans — but not health FSAs — are expressly allowed to pay employees' individual health insurance premiums upon receipt of appropriate substantiation. "Payment or reimbursement of employees' substantiated individual health insurance premiums is excludible from employees' gross income ... and is a qualified benefit for purposes of Section 125," the rules state (Treas. Reg. §1.125-1(m)(1)). The rules give this example:

- (i) An employer's cafeteria plan offers the following benefits for employees who are covered by an individual health insurance policy. The employee substantiates the expenses for the premiums for the policy (as required in paragraph (b)(2) in Treas. Reg. §1.125-6) before any payments or reimbursements

to the employee for premiums are made. The payments or reimbursements are made in the following ways: (ii) The cafeteria plan reimburses each employee directly for the amount of the employee's substantiated health insurance premium; (iii) The cafeteria plan issues the employee a check payable to the health insurance company for the amount of the employee's health insurance premium, which the employee is obligated to tender to the insurance company; (iv) The cafeteria plan issues a check in the same manner as (iii), except that the check is payable jointly to the employee and the insurance company (Treas. Reg. §1.125-1(m)(2)).

The premium reimbursement plan feature incorporates some Bush Administration-favored tax concepts making individual health coverage more accessible by affirming cafeteria plan reimbursement of individual pre-tax, salary-reduction purchases of health coverage directly from insurers.

These provisions also further consumer-directed health care (CDHC) by encouraging individuals to shop for and buy coverage suited to individual needs that may make appropriate coverage less costly. In addition, individual coverage is obtained with the tax advantages of other group health plan coverage.

The feature also could help make health coverage accessible to individuals who are otherwise excluded economically, and make the coverage available in a CDHC context. Individuals may buy HSA-qualifying high-deductible coverage on an individual basis more suited to their needs and thus be able to fund both individual policies and HSAs through pre-tax salary-reductions.

### **Written Requirement**

Consistent with previous proposed rules, the new rules require a cafeteria plan to be in writing. Lack of a written plan results in loss of the tax advantages of benefits offered and inclusion in the participant's gross income of the highest value benefits that the employees could have received. The plan must be adopted and effective on or before the first day of the cafeteria plan year to which it relates (Treas. Reg. §1.125-1(c)).

In the absence of final written rules, some courts refused to enforce the IRS' old proposed rules and upheld the tax benefits of cafeteria plans whose existence was proven in the absence of written plans. Also, some employers have operated POP forms of cafeteria plans without formal written cafeteria plans.

With the finalization of written requirements, courts are more likely to uphold the written requirement, and employers that fail to have written plans will be at greater risk of losing their plans' tax advantages.

The written cafeteria plan may be comprised of multiple documents. It may incorporate by reference benefits offered through other separate written plans, such as a Section 410(k) plan, or coverage under a dependent care assistance program under Section 129, without describing in full the benefits established through these other plans. But, for example, if the plan offers different maximum levels of coverage for dependent care assistance programs, the descriptions in the separate written plan must specify the available maximums.

The plan terms must apply uniformly to all participants, and must include specific information (see box at top of page 5).

The sponsor may amend the cafeteria plan at any time, but the amendment can only be effective for periods after the later of the adoption date or effective date of the amendment. Thus, the plan can only reimburse expenses under the new benefit that are incurred after the later of the adoption date or effective date (Treas. Reg. §1.125-1(c)(5)).

## Information the Written Plan Must Provide

The written plan must include the following:

- a specific description of each benefit available through the plan, including the periods during which the benefits are provided (the periods of coverage);
- the plan's participation rules, specifically limiting plan participation to employees only;
- the procedures governing employees' elections under the plan, including the period when elections may be made, the periods in which elections are effective, and the irrevocability of elections, except to the extent allowed under optional change in status rules in Treas. Reg. §1.125.1-4;
- how employer contributions may be made under the plan (for example, through an employee's salary reduction election or by nonelective employer contributions (that is, flex-credits, or both);
- the maximum amount of employer contributions available to any employee; and
- the plan year of the cafeteria plan.

If the plan offers additional benefits and options, then it must explain those in detail, too.

- If the plan offers paid time off, it must explain the required ordering rule for use of nonelective and elective paid time off.
- If the plan includes FSAs, it must explain the plan's provisions complying with any additional requirements for those FSAs (for example, the uniform coverage rule and the use-it-or-lose-it rules).
- If the plan includes a grace period, it must explain the plan's complying provisions.
- If the plan includes distributions from a health FSA to employees' HSAs, it must explain the plan's complying provisions.

The written plan requirement and specific content requirements are similar to those which the DOL requires for plan documents under the Employee Retirement Income Security Act (ERISA). However, while state and local governments are not subject to ERISA, they will be required to meet the cafeteria plans requirements if they offer such plans.

### Nondiscrimination

The proposed rules, for the first time in more than 20 years, try to elaborate on the application of various nondiscrimination rules to cafeteria plans. Cafeteria plans cannot favor highly compensated individuals (HCIs) as to eligibility, or favor highly compensated participants as to contributions and benefits (Treas. Reg. §1.125-7). In applying this eligibility test, certain individuals are allowed to be disregarded, including COBRA qualified beneficiaries. In other words, the test is run based on the active employee population (Treas. Reg. §1.125-7(b)(3)(ii)(C)).

### Critical Nondiscrimination Provisions

Critical provisions in the new proposed nondiscrimination rules include:

- definition of a highly compensated participant (HCP) or highly compensated individual (HCI);
- definition of an officer;
- definition of HCIs;
- incorporation of the eligibility test from pension rules (Treas. Reg. §1.410(b)) including the safe harbor;
- incorporation of an objective benefits test in the contribution and benefits test;
- an objective key employee test; and
- a premium only plan (POP) safe harbor.

The rules apply to cafeteria plans generally, and specifically to HSAs offered through a cafeteria plan and health FSAs. (See box bottom right on page 5.)

Under the safe harbor provisions, plans that meet certain criteria fall within a safe harbor, that is, are deemed nondiscriminatory.

### *Definitions*

Under the new proposed rules, an HCI means an individual who is:

- 1) an officer;
- 2) a 5-percent shareholder; or
- 3) highly compensated (Treas. Reg. §1.125-7(a)(3)(i)).

Spouses and dependents of HCIs also are HCIs (Treas. Reg. §1.125-7(a)(3)(ii)).

A highly compensated participant (HCP) means an HCI who is eligible to participate in a cafeteria plan (Treas. Reg. §1.125-7(a)(4)).

An “officer” for the nondiscrimination test means an individual or participant who for the preceding year was an officer. Status as an officer depends on the source of the individual’s authority, the term of his or her election or appointment, and the nature and extent of duties. Generally, the term “officer” means an administrative executive who is in regular and continued service. The officer title without authority is not an “officer” for the rules’ nondiscrimination purposes (Treas. Reg. §1.125-7(a)(7)).

A “key employee” is defined as under pension provisions (Code Section 416) as an employee who is an:

- 1) officer with compensation above a defined threshold (indexed) for the plan year as defined in the Section 415(b)(1)(A));
- 2) one of 10 employees having annual compensation above a threshold amount as defined in Section 415(c)(1)(A)) and owning the largest interests in the employer;
- 3) a 5-percent owner of the employer; or
- 4) a 1-percent owner having annual compensation from the employer of more than a threshold amount as defined in Section 416 (Treas. Reg. §1.125-7(a)(10)).

### *Eligibility test*

Cafeteria plans cannot discriminate as to eligibility in favor of HCIs. The proposed cafeteria plan rules incorporate the pension plan safe-harbor percentage test for eligibility from Treas. Reg. §1.410. Under this test, a certain minimum percentage of nonhighly compensated individuals must be benefiting under the plan relative to a certain percentage of HCIs (Treas. Reg. §1.125-7(b)).

If enough rank-and-file employees benefit relative to the number of HCIs benefiting, the plan falls within what is called a safe harbor — or a zone of ratios automatically deemed not to discriminate (Treas. Reg. §1.125-7(b)).

If the ratio of rank-and-file employees benefiting in the cafeteria plan relative to the HCIs is too low, then the plan is deemed discriminatory. However, a plan that fails the ratios test may yet qualify under another part of the test referred to as the facts-and- circumstances test (Treas. Reg. §1.125-7(b)). For example, there may be a legitimate business reason for discriminatory eligibility, such as rank-and-file employees residing outside an HMO service area who thus do not qualify for plan coverage.

### *Contributions and benefits test*

Under another test, a cafeteria plan cannot discriminate in favor of HCPs regarding contributions and benefits (Treas. Reg. §1.125-7(c)(1)). A plan must give each similarly situated participant a uniform chance to elect qualified benefits, and the HCPs must not in disproportionate numbers actually elect those benefits (Treas. Reg. §1.125-7(c)(2)).

Under the benefits test, disproportionate election exists if the aggregate qualified benefits that HCPs elect, measured as a percentage of their aggregate compensation, exceeds the aggregate qualified benefits that nonhighly compensated participants elect, measured as a percentage of their aggregate compensation (Treas. Reg. §1.125-7(c)(2)).

**Example.** Contel's cafeteria plan meets eligibility requirements. HCPs in the plan elect aggregate qualified benefits equaling 5 percent of aggregate compensation; nonhighly compensated participants elect aggregate qualified benefits equaling 10 percent of aggregate compensation. Contel's cafeteria plan passes the contributions and benefits test.

### *Key employees test*

There also is a key employees test. If nontaxable benefits provided to key employees exceed 25 percent of the aggregate nontaxable benefit provided for all employees through the cafeteria plan, each key employee includes in gross income an amount equaling the maximum taxable benefits that he or she could have elected for the plan year (Treas. Reg. §1.125-7(d)(1)).

However, there is a safe harbor for POPs under which a POP passes the contributions and benefits test and the key employee test if it meets the safe harbor percentage test for eligibility described above (Treas. Reg. §1.125-7(f)(1)).

To illustrate the key employees test:

**Example.** Employer Durango's cafeteria plan offers all employees an election between taxable benefits (such as cash) and qualified benefits (such as excludable health benefits) and meets the eligibility test. Durango has two key employees and four nonhighly compensated employees. Key employees each elect \$2,000 of qualified benefits. Each nonhighly compensated employee also elects \$2,000 of qualified benefits.

Key employees receive \$4,000 of nontaxable benefits and nonhighly compensated employees receive \$8,000 of nontaxable benefits, for a total of \$12,000. Key employees receive 33 percent of nontaxable benefits. Because the plan provides more than 25 percent of aggregate nontaxable benefits to key employees, the plan fails the key employee concentration test (Treas. Reg. §1.125-7(d)(2)).

To illustrate the POP safe harbor:

**Example.** Employer Fox's written POP offers one health plan and offers all employees the election to salary reduce the same amount or same percentage of the premium for self-only or family coverage. All key employees and all highly compensated employees elect salary reduction for the health plan, but only 20 percent of nonhighly compensated employees elect the health plan (Treas. Reg. §1.125-7(f)(2)(i)).

The POP satisfies the eligibility and contributions and benefits tests (Treas. Reg. §1.125-7(f)(2)(ii)).

### *Health plan safe harbor*

In addition, there is a contributions and benefits test safe harbor for group health plans — but not dental or health FSAs. The safe harbor applies if the contribution on behalf of each participant equals 100 percent of the cost of health coverage of the majority of similarly situated HCPs, or at least equals 75 percent of the cost of health coverage of the similarly situated participant with the highest cost health coverage under the plan (Treas. Reg. §1.125-7(e)(1)).

### *Aggregation*

Employers that sponsor more than one cafeteria plan have the option to aggregate plans for nondiscrimination testing purposes, which could provide flexibility particularly to employers in industries with high turnover or low participation rates, for example (Treas. Reg. §1.125-7(g)(2)).

Plans are required to do nondiscrimination testing annually. Tests must be done as of the last day of the plan year (Treas. Reg. §1.125-7(j)(1)).

**Example.** Employer Hoopla has three employees and maintains a calendar year cafeteria plan. During 2009 Jay was an employee the entire year, Kay was an employee from May 1 through Aug. 31, 2009, and Lai was an employee from Jan. 1 to April 15, 2009.

Nondiscrimination testing must be done for the 2009 plan year and must be performed on Dec. 31, 2009, taking into account employees Jay, Kay and Lai's compensation in the preceding year (Treas. Reg. §1.125-7(j)(2)).

### **Elections**

For a cafeteria plan to qualify, employees must have a choice between permitted taxable benefits (such as cash/salary) and qualified benefits (such as health, dental, etc.) (Treas. Reg. §1.125-2). Elections must be made before the earlier of the date benefits are available or before the plan year begins (Treas. Reg. §1.125-2(a)(1)(2)).

Election changes are not permitted except under limited circumstances, such as for status changes. Essentially, the new proposed rules remain the same as under the old proposed rules and subsequent guidance. The rules do incorporate the exception to mid-year election changes for HSAs. For HSAs, election changes for contributions may be made prospectively on a monthly or more frequent basis, for example (Treas. Reg. §1.125-2(a)(4)).

The proposed rules incorporate authority to have “negative elections” or automatic elections for health coverage for new and current employees; however, the procedures for automatic enrollment need to be described in the plan's written materials (Treas. Reg. §1.125-2(b)(1)).

The automatic election should be distinguished from mandated participation. What distinguishes automatic enrollment is that the new hire or current employee may choose not to be automatically enrolled.

**Example.** Employer Bubba offers a calendar year cafeteria plan with health benefits as an option for employee-only or family coverage. The plan provides automatic enrollment: each new employee and each current employee is automatically enrolled in employee-only coverage and the employee's salary is reduced to pay the employee's share of premium unless the employee affirmatively elects cash. Alternatively, if the employee has a spouse or child, he or she can elect family coverage.

When an employee is hired, he or she receives a notice explaining the automatic enrollment process and the employee's right to decline coverage and have no salary reduction. The notice includes the salary reduction amounts for employee-only and family coverage, procedures for exercising the right to decline coverage, information on the time by which an election must be made, and the period for which an election is effective. The notice also is given to each current employee before the beginning of each subsequent plan year, except that the notice for each current employee includes a description of his or her existing coverage.

For new employees, an election to receive cash or to have family coverage rather than employee-only coverage is effective if made when the employee is hired. For a current employee, an election is effective if made before the start of each calendar year or under any other circumstances permitted under the cafeteria plan rules. An election made for any prior year is deemed to be continued for every succeeding plan year, unless changed.

Contributions for health coverage through the cafeteria plan are not includible in gross income of the employees solely because the plan provides for automatic enrollment as a default election in which employees' salary is reduced each year to pay for a portion of health coverage (unless the employee affirmatively elects cash) (Treas. Reg. §1.125-2(b)(2)).

The proposed rules also permit cafeteria plans to provide an optional election for new employees between cash and qualified benefits if they make an election within 30 days after the date of hire even if benefits provided under the election relate back to the date of hire. However, salary reduction to pay for such an election must be from compensation not yet currently available on the date of the election (Treas. Reg. §1.125-2(d)).

## **Flexible Spending Arrangements**

The old proposed rules provided the basic framework and rules for health FSAs and dependent care FSAs. The new proposed rules also incorporate adoption assistance programs designed as FSAs (Treas. Reg. §1.125-5(h)).

Health FSAs are accounts funded by employee pre-tax, salary reductions, employer tax-free contributions, or both. These accounts are exclusively for health expenses that are not otherwise reimbursed. The rules remain substantially the same under the new proposed rules (Treas. Reg. §1.125-5). Among them are:

- the maximum reimbursement must be available at all times during the coverage period (the employer at-risk rule) (Treas. Reg. §1.125-5(a)(2));
- the requirement for a 12-month coverage period with the availability of a limited grace period should plan sponsors choose to offer it (Treas. Reg. §1.125-5(e)(1));
- only medical expenses can be reimbursed (Treas. Reg. §1.125-5(k));
- third party substantiation must take place before reimbursement (Treas. Reg. §1.125-6);
- expenses must be incurred during the coverage period (Treas. Reg. §1.125-5(a)(1)); and
- the use-it-or-lose-it rule (Treas. Reg. §1.125-5(c)(1)).

The rules retain the rule for limited distribution of FSA account balances for deposit in HSAs (Treas. Reg. §1.125-5(n)), which the IRS recently issued.

Concerning FSAs, other key provisions include:

- Employers may limit health FSA participation to those employees who participate in the employer's general health plans (Treas. Reg. §1.125-5(g)(1)).
- Plans are allowed to limit health FSA reimbursements to certain Code Section 213 medical expenses; they may, for example, exclude coverage for over-the-counter drugs (Treas. Reg. §1.125-5(k)(2)).
- Exceptions to the prohibition on deferred compensation in a cafeteria plan are incorporated, such as to allow advance payments for orthodontia before the services are provided (Treas. Reg. §1.125-5(k)(3)(i)).
- The prohibition on FSA reimbursement of premiums for other health coverage is retained (Treas. Reg. §1.125-5(k)(4)).
- Provisions are clarified on allowable payments and timing of payments regarding combination limited-purpose and post-deductible health FSAs. The provisions allow reimbursement for dental, vision and prevention before the deductible is met (Treas. Reg. §1.125-5(m)(3)(4)).

## **Forfeitures**

In a significant clarification on use of health FSA experience gains, the proposed rules allow employers simply to take unused funds in health FSAs that are forfeited. These funds, called experience gains, may also be used to defray plan administrative costs if allocated on a uniform basis that is not based on individual claims experience to the following year's FSAs, or returned to the participants on a uniform basis (Treas. Reg. §1.125-5(o)).

Employers should consider DOL fiduciary and plan asset rules, however, before simply taking forfeitures for employer use. Such use may be available only in limited circumstances. Such funds may be deemed plan assets and not available to employers, or if allowed, only on a minimum basis. There could be fiduciary and prohibited transactions issues for plan sponsors who are fiduciaries and decide to use experience gains for employer use.

### *Dependent care assistance*

In general, the proposed rules restate the general rules for providing dependent care FSAs through a cafeteria plan. As with health FSAs, dependent care expenses may not be reimbursed before the expenses are incurred. Dependent care expenses are incurred when the care is provided — not when the employee is formally billed, charged for or pays for the dependent care (Treas. Reg. §1.125-6(a)(4)(i)).

A new optional rule permits an employer to reimburse a terminated employee's qualified dependent care expenses incurred after termination through a dependent care FSA, if all Section 129 requirements are otherwise satisfied (Treas. Reg. §1.125-6(a)(4)(v)).

## **Substantiation**

Substantiation of claims before payment or reimbursement is required for all qualified benefits in cafeteria plans. Only expenses incurred during the cafeteria plan period may be paid or reimbursed. The new proposed rules (Treas. Reg. §1.125-6) incorporate old proposed rules and various interpretations and guidance issued subsequently, particularly substantiation requirements under FSA guidance issued in 2006 and 2007 regarding the use of various payment cards.

The proposed rules clarify that all cafeteria plan expenses must be substantiated with third-party evidence (receipts, for example) before payment or reimbursement. A cafeteria plan can pay or reimburse only substantiated expenses for claims incurred on or after the later of the effective date of the plan or the date the employee is enrolled in the plan (Treas. Reg. §1.125-6(b)(3)(i)).

The requirements mean all claims for benefits must be substantiated. It is not enough to substantiate samplings or percentages of claims, or only those claims above a certain amount. Self-substantiation will not suffice (Treas. Reg. §1.125-6(b)(2)(3)).

The plan sponsor ultimately is responsible for ensuring that mechanisms are in place for member receipts to be verified before transfers are allowed from pre-tax accounts.

Plan sponsors with electronic payment card programs must provide that cards are automatically canceled when employees cease to participate in the health FSA. In addition, employees must agree in writing to use the card only for medical expenses (Treas. Reg. §1.125-6(d)(1)(4)).

Although the proposed rules use the term “debit card,” the requirements also apply to credit and stored value cards used to pay health expenses.

## **COBRA Administration**

The proposed rules have many provisions that will affect how an employer runs its COBRA program, including in conjunction with a cafeteria plan.

### *COBRA premiums are “qualified benefits”*

Under a cafeteria plan, participants must be provided a choice between cash (or taxable benefits) and a “qualified benefit.” Ordinarily, qualified benefits include benefits like health or life insurance coverage.

Under the proposed rules, the IRS would specifically permit a cafeteria plan (but not a health FSA) to pay or reimburse substantiated individual accident and health insurance premiums. In addition, a cafeteria plan may provide for payment of an employee’s COBRA premiums under the group health plan of the employer sponsoring the cafeteria plan or under a group health plan that a different employer is sponsoring (like the employee’s former employer). (See Treas. Reg. §1.125-1(l).)

**Example.** Employer X maintains a cafeteria plan for full-time employees, offering an election between cash and employer-provided group health insurance (and maybe even other qualified benefits). Employees A, B and C participate in Employer X’s cafeteria plan.

Now consider how these employees might pay for COBRA coverage through a cafeteria plan:

**Scenario 1.** On July 1, 2009, Employee A, a full-time employee, goes part time and loses coverage under X’s group health plan. That is a COBRA qualifying event. Under the proposed rules, A is allowed to modify her salary reduction election to pay for her COBRA coverage on a pre-tax basis.

**Scenario 2.** Employee B previously worked for another employer, quit and elected COBRA coverage from that employer. B begins work for Employer X on July 1, 2009, and becomes eligible to participate in X’s cafeteria plan on July 1, 2009, but will not be eligible to participate in X’s group health plan until Oct. 1, 2009. The proposed rules would permit Employee B to reduce his salary on a pre-tax basis to pay the COBRA premiums for coverage under the group health plan of B’s former employer.

Before considering Employee C, note that the issue of having a new employer pay for the COBRA coverage under a former employer's plan raises some interesting compliance problems. Does the fact that the new employer is paying the premiums for that coverage on a tax-favored basis mean that the new employer is "maintaining" the old employer's plan? If that were the case, issues could arise as to whether the new employer is somehow responsible for any subsequent qualifying events or COBRA compliance matters if the employee incurs a qualifying event while that coverage arrangement is in place.

Generally, based on the few reported court cases that have considered these issues, if the new employer is simply reimbursing the premiums the employee pays or owes to the former employer, then the arrangement should not result in the new employer "maintaining" the old employer's plan. The issues could become murky if the new employer were actually to pay the old employer directly.

**Scenario 3.** Employee C and C's spouse are covered under Employer X's accident and health plan until July 1, 2009, when C's divorce from her spouse became final. That divorce causes C's ex-spouse to lose coverage under the group health plan and C's spouse incurs a COBRA qualifying event. C continues to be covered under the group health plan. On July 1, 2009, C requests to pay the COBRA premiums for her former spouse (who is not C's tax dependent after the divorce) through the cafeteria plan. In this case, C cannot pay for C's ex-spouse on a pre-tax basis because the ex-spouse is not a tax dependent. Therefore, C has to pay for the COBRA coverage with after-tax employee contributions.

Although COBRA premiums are qualified benefits and may be paid for through a pre-tax salary reduction election, note that COBRA premiums are not allowed to be reimbursed through a health FSA. This can be a confusing point; but this important distinction needs to be kept in mind. If a plan document is drafted incorrectly and allows for reimbursement of premiums through an FSA, the cafeteria plan will be disqualified.

Another form of "salary reduction" for COBRA premiums could apply in the severance pay context. When employers maintain severance pay arrangements, they often allow former employees to continue their group health plan coverage for a certain period. In addition, during that protected period, the employer often subsidizes the premiums — the former employees are allowed, for example, to pay employee rates and do not have to pay the full COBRA cost. Under the proposed rules, COBRA premiums are qualified benefits. Therefore, an employer's cafeteria plan could allow a terminating employee to pay the COBRA premium amount on a pre-tax basis by reducing the severance pay just like a salary reduction contribution (Treas. Reg. §1.125.1(l)).

### *Grace period issues*

One of the fundamental cafeteria plan rules is one that says that all claims must be incurred during the "period of coverage" — typically the plan year. This is also referred to as the "use-it-or-lose-it" rule. That is, if a participant did not use all of the available benefits by the end of the relevant period, the cafeteria plan benefits would be lost (or forfeited).

In 2005, in response to mounting criticism of the "use-it-or-lose-it" rule, the IRS issued guidance allowing cafeteria plans to implement a grace period immediately following the end of each plan year during which participants could continue to incur claims and use cafeteria plan benefits accrued during the prior plan year. A grace period may apply to one or more qualified benefits (for example, health FSA or dependent care assistance program) but in no event could it apply to paid time off or contributions to Section 401(k) plans.

The proposed rules incorporate the grace period provisions and add some clarifications. One of the rules governing the use of the grace period is that it must apply to all employees who are participants as of the last day of the plan year. For this purpose, COBRA qualified beneficiaries who are employees or former employees are taken into account (Treas. Reg. §1.125-1(e)(1)). This means that the grace period rule must extend to COBRA qualified beneficiaries (who are employees or former employees) as well as the other active non-COBRA beneficiaries. Similarly, participants who are active on the last day of the year but terminate during the grace period must be able to take advantage of any grace period applicable under the plan (Treas. Reg. §1.125-1(e)(3)(i)).

**Example 1.** Employer Y maintains a cafeteria plan with a grace period allowing all participants to apply unused benefits or contributions remaining at the end of the plan year to qualified benefits incurred during the grace period immediately following that plan year. For the plan year ending Dec. 31, 2009, the grace period ends March 15, 2010.

**Example 2.** Now assume that Employees A and B each elected on a timely basis \$1,200 salary reduction for a health FSA for the plan year ending Dec. 31, 2009. Employees A and B terminated employment on Sept. 15, 2009 and incurred a COBRA qualifying event as a result. Each has \$500 of unused benefits or contributions in the health FSA. Now compare two employees — A and B.

Employee A elected and paid for COBRA coverage for the health FSA through the end of the year. Employee A is a participant in the cafeteria plan as of Dec. 31, 2009, the last day of the 2009 plan year. Employee A has \$500 of unused benefits or contributions available during the grace period for the 2009 plan year (ending March 15, 2010). By contrast, Employee B did not elect COBRA for the health FSA. Employee B is not a participant in the cafeteria plan as of Dec. 31, 2009. The grace period does not apply to Employee B.

### *Refunds to terminated participants*

The proposed rules clarify that when an employee ceases to be a participant, the cafeteria plan must pay him or her any amount he or she previously paid for coverage or benefits to the extent the previously paid amount relates to the period from the date he or she ceases to be a participant through the end of that plan year. In other words, if a participant pre-paid for coverage during future months, that prepayment must be refunded upon his or her termination of employment (Treas. Reg. §1.125-5(d)(3)).

After explaining this rule, the proposed rules rather cryptically then refer to the ability to elect COBRA coverage regarding a health FSA (Treas. Reg. §1.125-5(e)(2)). It is not clear what this cryptic reference means. Perhaps the IRS is trying to point out that the prepayment could actually be used as a prepayment of COBRA coverage for peri-

## **Comments Invited**

Interested persons have through Nov. 5, 2007 to file their comments on the new proposed cafeteria plan rules. Consideration will be given to any written or electronic comments timely submitted. In addition, the IRS and Treasury Department specifically request comments on the clarity of the proposed rules and how they can be made easier to understand.

They also have requested comment on the following issues:

- 1) whether, consistent with Section 125, multiple employers (other than members of a controlled group described in Section 125(g)(4)) may sponsor a single cafeteria plan;
- 2) whether salary reduction contributions may be based on employees' tips and how that would work;
- 3) how, when a participant has a change in status under Treas. Reg. §1.125-4 and changes his or her salary reduction amount, the participant's uniform coverage amount should be computed after the change in status.

ods after termination instead of being applied as a refund. If that is the case, it would be helpful to know whether the cafeteria plan could choose to mandate that the funds be retained as a prepayment for COBRA coverage rather than implement the refund. Perhaps future guidance will clarify this question.

## Conclusion

This discussion highlights some of the key issues and concerns to consider in reviewing the new IRS proposed rules. Undoubtedly, as practitioners work through them and try to apply them to real life scenarios, more issues will come up. That is why, even though the official effective date is 2009, it is important for employers and administrators to start working with the rules now. Then problem areas or unclear points can be raised to the IRS and, hopefully, clarified before the rules are finalized.

# Flex Plan Handbook

### In one source you'll find out:

- How to identify a reimbursable expense under a flexible spending account
  - How to simplify initial enrollment
  - How to conduct nondiscrimination tests
  - How to gather, record and report data easily and cost-effectively
  - What plan funding alternatives are best for your organization
  - Whether medical savings accounts are right for you
  - What related measures are now before Congress and the IRS
- And much more!

## Flex Plan Handbook

### Trial Subscription Certificate

**YES!** Please enter my one-year subscription and send me *Flex Plan Handbook* to use and evaluate risk-free for 30 days. Within that time, I'll either return the materials and owe nothing . . . or honor your invoice for **\$399**. My subscription includes the *Handbook*, regular updates and newsletters.

Name \_\_\_\_\_

Title \_\_\_\_\_

Organization \_\_\_\_\_

Address \_\_\_\_\_

City \_\_\_\_\_

State \_\_\_\_\_

Zip \_\_\_\_\_

Signature \_\_\_\_\_

(required on all orders)

FLEX BL112015

**Bill me.** (\$399 plus \$24.50 s/h.)

**Payment enclosed.** (\$399 plus \$24.50 s/h.)  
Please make check payable to Thompson Publishing Group, Inc. Residents of DC, FL and NY, please add appropriate sales tax.

#### Mail to:

Thompson Publishing Group  
Subscription Service Center  
PO Box 26185 • Tampa, FL 33623-6185  
Call: 800 677-3789



## Human Resources Series

*ADA Compliance Guide*  
*Coordination of Benefits Handbook*  
*Domestic Partner Benefits: An Employer's Guide*  
*Educator's Guide to Controlling Sexual Harassment*  
*Employer's Guide to Fringe Benefit Rules*  
*Employer's Guide to HIPAA Privacy Requirements*  
*Employer's Guide to Self-Insuring Health Benefits*  
*Employer's Guide to the Fair Labor Standards Act*  
*Employer's Guide to the Health Insurance Portability & Accountability Act*  
*Employer's Guide to Military Leave Compliance*  
*Employer's Handbook: Complying with IRS Employee Benefits Rules*  
*Fair Labor Standards Handbook*  
*Family & Medical Leave Handbook*  
*FLSA Employee Exemption Handbook*  
*Guide to Assigning & Loaning Benefit Plan Money*  
*Guide to Consumer-Directed Health Care*  
*HR Guide to Business Continuity Planning*

*HR Question and Answer Book*  
*Human Resources 2007: Answers to Your Top 25 Questions*  
*Investigating Sexual Harassment: A Practical Guide to Resolving Complaints*  
*Labor and Employment Law: The Employer's Compliance Guide*  
*Mandated Health Benefits: The COBRA Guide*  
*Pension Plan Fix-It Handbook*  
*Public Employer's Guide to FLSA Employee Classification*  
*The 401(k) Handbook*  
*The Flex Plan Handbook*  
*The Leave and Disability Coordination Handbook*  
*Thompson's Employee Handbook Builder*  
*Thompson's HR Employment Forms*  
*Workplace Accommodations Under the ADA*  
*Workplace Privacy: Real Answers & Practical Solutions*  
*Understanding and Preventing Workplace Retaliation*

For more information about any of these Thompson products, please contact us:

**Call:** 1-800-677-3789  
**Online:** [www.thompson.com](http://www.thompson.com)  
**Fax:** 1-800-999-5661  
**Email:** [service@thompson.com](mailto:service@thompson.com)  
**Mail:** Thompson Publishing Group  
Subscription Service Center  
PO Box 26185, Tampa, FL 33623-6185