

**IRS RELEASES NEW PROPOSED  
CAFETERIA REGULATIONS**

**An Explanation**

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## Introduction

On August 6, 2007, the IRS withdrew all of the proposed regulations still outstanding and issued a new set of proposed regulations, providing comprehensive guidance on Code Section 125, including definitions of qualified and nonqualified benefits; general rules on elections, flexible spending arrangements and substantiation of expenses; and nondiscrimination rules. These new proposed regulations consolidate rules included in the prior proposed regulations, as well as in a number of notices and revenue rulings. They retain many of the rules from the prior proposed regulations, but also include many new rules, such as detailed nondiscrimination requirements based on the rules for qualified retirement plans, requirements for the terms of the written plan document and the time the plan must be adopted, and several anti-abuse rules. The regulations are proposed to be effective January 1, 2009. This discussion follows the organization of the regulations.

### 1.125-1 - Cafeteria plans; general rules

- 1. Definition of Cafeteria Plan:** Participants in a cafeteria plan must be permitted to choose among at least one permitted taxable benefit (for example, cash, including salary reduction) and at least one qualified benefit. A permitted taxable benefit means cash and certain other taxable benefits treated as cash. Any plan offering only elections among taxable benefits is not a cafeteria plan. Cash means cash compensation (including salary reduction), payments for annual leave, sick leave or other paid time off and severance pay. Other taxable benefits treated as cash include, property, benefits attributable to employer contributions that are currently taxable to the employees and benefits purchased with after-tax employee contributions. A qualified benefit means a nontaxable permitted benefit.

Comment: It is made clear that a plan is not a cafeteria plan unless an employee can opt out of coverage under a qualified benefit and receive cash or a taxable benefit.

- 2. Dependent:** The definition of dependent for medical benefit purposes has been changed to reflect law changes under the Working Families Tax Relief Act of 2004 and Notice 2004-79. In the past a dependent meant an individual that qualified as a dependent as defined under Code Section 152. For tax years beginning in 2005, it is now defined as a dependent as defined in Code Section 152, determined without regard to Code Section 152(b)(1), (b)(2) or (d)(1)(B). This means any individual who is your tax dependent, but not applying the requirements that:
  - (a) an individual who is the dependent of another taxpayer is treated as having no dependents,
  - (b) a married individual who files a joint return cannot be a dependent, and
  - (c) gross income of a “qualifying relative” must be less than the exemption amount and with the following exception, (regarding a child of divorced parents, etc., where one or both parents have custody of the child for more than half of the

calendar year and where the parents together provide more than half of the child's support for the calendar year) is treated as a dependent of both parents).

For purposes of this section a "qualifying relative is defined as an individual who (1) has a relationship with the taxpayer as set forth in federal law, such as child, brother or sister, or father or mother, (2) receives over one-half of his or her support from the taxpayer and (3) has income that does not exceed the exemption amount for the tax year.

Comment: This change is effective now and cafeteria plans should have been amended to reflect this change.

3. **Severance Pay.** The regulations have made it clear that an employer can give terminating employees receiving severance pay an election between receiving severance pay and using the severance pay to pay the COBRA premiums for accident and health plans.
4. **Written plan requirement:** A cafeteria plan must now satisfy new detailed requirements:
  - The plan must be adopted in writing on or before the first day it is effective, and any amendment must be adopted in writing by the date it is effective;
  - The terms of the plan must apply uniformly to all participants;
  - The plan must include descriptions of the benefits available, rules for participation and elections, any grace period used, and a number of other specified terms;
  - If the plan allows employees to elect paid time off, ordering rules require that any nonelective time off be used first and that these rules be included in the plan;
  - The plan year must be specified in the plan and must be 12 months; and
  - The plan year can be changed only for valid business reasons, and a short plan year is permitted only for a new plan or for another valid business purpose.
5. **Operational failure:** The regulations make it made clear that if a cafeteria plan fails to operate according to its written plan or otherwise fails to operate in compliance with Code Section 125 and the regulations, the plan is not a cafeteria plan and employees' elections between taxable and nontaxable benefits result in gross income to all employees.
6. **Changing the plan year:** An employer may only change the plan year for a cafeteria plan if it is for a valid business purpose. An example in the regulations provides that if an employer changes a cafeteria plan's plan year to coincide with a health plan's plan year, the IRS will find that it was a valid business purpose.

7. **Grace Period:** These provisions do not apply to paid time off and elective contributions under a 401(k) plan made through a cafeteria plan. It also provides that an employee terminates employment during the grace period, he or she will continue to participate in the cafeteria plan for any unused amounts carried over to the grace period.
8. **Employee:** The term employees include common law employees, leased employees, full time life insurance salesman or any former employee who were any of the above. Former employees may participate in a cafeteria plan, but a plan may not be established or maintained predominantly of the benefit of former employees.
9. **Certain dual status individuals:** If an individual is an employee of an employer and also provided services to that employer as an independent contractor or director, the individual is eligible to participate in the employer's cafeteria plan solely in his or her capacity as an employee. This rule does not apply to partners or to 2% shareholders of an S corporation.

In addition, it also provides that if a 2-percent shareholder sells all of his stock to an unrelated third party and ceases to be a 2-percent shareholder during the plan year, that individual cannot participate in the cafeteria plan for the plan year of the sale.

10. **Coverage for individuals other than the employee's spouse or dependents with after-tax employee contributions:** A cafeteria plan is permitted to allow employees to elect accident and health coverage of an individual who is no longer a spouse or a dependent of the employee as a taxable benefit.
11. **Group term life insurance:** A cafeteria plan may permit employees to elect group-term life insurance in excess of \$50,000. These regulations change the rules of Notice 89-110 and provide that the taxable amount to the employee is limited to the amount determined under the Code Section 79.
12. **COBRA premiums:** COBRA premiums for employer-provided group health plan are qualified benefits if (1) the premiums are excludable from the employees' income under Code Section 106 or (2) the premiums are for accident and health plan of the employer sponsoring the cafeteria plan, even if the fair market value of the premiums is includable in the employee's gross income.

It is also provided in the examples that an employer can reimburse an employee for COBRA premiums of another employer on a pretax basis. In addition an employee can pay for his ex-spouse's premiums through the cafeteria plan on an after-tax basis.

13. **Individual Premiums:** The payment or reimbursement of employees' substantiated individual health insurance premiums are excludable from employees' gross income under Code Section 106 and are a qualified benefit for purposes of Code Section 125. The payments or reimbursements can be made in the following ways:

- (a) The cafeteria plan reimburses each employee directly for the amount of the employee's substantiated health insurance premium;
- (b) 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; or
- (c) The cafeteria plan issues a check in the same manner as (b), except that the check is payable jointly to the employee and the insurance company.

Comment: Despite the provisions of the new regulations that allows the inclusion of individual premiums as a permitted benefit under a cafeteria plan, an employer should be concerned about the application of ERISA, COBRA and HIPAA to this inclusion.

- 14. Paid time off:** In order to avoid the deferral of compensation, the cafeteria plan must preclude any employee from using paid time off or receiving cash, in a subsequent plan year, for any portion of such paid off remaining unused as of the end of the plan year. The grace period discussed above does not apply to paid time off.

The regulations provide that a cafeteria plan can permit employees to exchange up to paid time off to pay the employee's share of accident and health insurance premiums. Such exchange would be nontaxable.

- 15. Qualified benefits - Mandatory 2-year election for vision or dental insurance:** When a cafeteria plan offers vision or dental insurance that required a mandatory 2-year coverage, but no longer, the mandatory 2-year coverage period does not result in deferred compensation in violation of the prohibition against deferred compensation under Code Section 125(d), provided both of the following requirements are satisfied (a) the premiums for each year are paid no less frequently than annually and (b) in no event does the cafeteria plan use salary reduction or flex-credits relating to the first year of a 2-year election to apply to vision or dental insurance for the second year of the 2-year election.

- 16. Qualified benefits - Using salary reduction amounts from one plan year to pay accident and health premiums for the first month of the immediately following plan year:** Salary reduction amounts from the last month of one plan year of a cafeteria plan may be applied to pay accident and health insurance premiums for insurance during the first month of the immediately following plan year, if done on a uniform and consistent basis with respect to all participants (based on the usual payroll interval for each group of participants).

- 17. Qualified Benefits:** Qualified benefits may also include contributions for post-retirement group life coverage meeting certain conditions for employees of an educational organization.

- 18. Nonqualified benefits:** Several benefits are considered nonqualified benefits:

- (a) Group-term life insurance on the life of any individual other than an employee (whether includible or excludible from the employee's gross income); and
- (b) Elective deferrals to a section 403(b) plan.

### **1.125-2 - Cafeteria plans - elections**

- 1. Elections not required on written paper documents:** A cafeteria plan may permit employees to use electronic media for such transactions. The safe harbor in Treasury Regulations Section 1.401(a)-21 applies to electronic elections, revocations and changes in elections under Code Section 125.
- 2. Automatic Elections for Health Plans:** For an employer to impose an automatic election when an employee is hired, the employer must provide the employee with a notice explaining the automatic enrollment process and the employee's right to decline coverage and have no salary reduction. The notice must include the salary reduction amounts for employee-only coverage and family coverage, procedures for exercising the right to decline coverage, information on the time by which an election is made, and the period for which an election is effective. This notice must be provided to each current employee before the beginning of each subsequent plan year.
- 3. Election Rules for salary reduction contributions to HSAs:** If a cafeteria plan offers HSA contributions as a qualified benefit, the plan must:
  - (a) Specifically describe the HSA contribution benefit;
  - (b) Allow a participant to prospectively change his or her salary reduction election for HSA contributions on a monthly basis (or more frequently); and
  - (c) Allow a participant who becomes ineligible to make HSA contributions to prospectively revoke his or her salary reduction election for HSA contributions.
- 4. Optional election for new employees:** A cafeteria plan may provide new employees 30 days after their hire date to make elections between cash and qualified benefits. The election is effective as of the employee's hire date. However, salary reduction amounts used to pay for such an election must be from compensation not yet currently available on the date of the election. The written cafeteria plan must provide that any employee who terminates employment and is rehired within 30 days after terminating employment (or who returns to employment following an unpaid leave of absence of less than 30 days) is not a new employee eligible for the election.

### **1.125-5 - Flexible Spending Arrangements**

- 1. Maximum Amount of reimbursement:** The maximum amount of reimbursement that is reasonably available to an employee for a period of coverage must not be substantially

in excess of the total salary reduction and employer flex-credit for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total salary reduction and employer flex-credit if such maximum amount is less than 500 percent of the combined salary reduction and employer flex-credit. A single FSA may provide participants with different levels of coverage and maximum amounts of reimbursement.

2. **Flex credits allowed:** These credits can be used at the employee's election only for one or more qualified benefits (but not as cash or a taxable benefit).
3. **Terminated participants:** When an employee terminates, 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.
4. **Separate period of Coverage:** Dependent care assistance, adoption assistance and a health FSA are each permitted to have a separate period of coverage, which may be different from the plan year of the cafeteria plan.
5. **FSA administrative practices - Limiting health FSA enrollment to employees who participate in the employer's accident and health plan:** At the employer's option, a cafeteria plan is permitted to provide that only those employees who participate in one or more specified employer-provided accident and health plans may participate in a health FSA.
6. **Interval for employees' salary reduction contributions:** The cafeteria plan is permitted to specify any interval for employees' salary reduction contributions. The interval specified in the plan must be uniform for all participants.
7. **Qualified benefits permitted to be offered through an FSA:** Dependent care assistance (Code section 129), adoption assistance (Code section 137) and a medical reimbursement arrangement (Code section 105(b)) are permitted to be offered through an FSA in a cafeteria plan.
8. **Limiting payment or reimbursement to certain Code Section 213(d) medical expenses:** A health FSA is permitted to limit payment or reimbursement to only certain Code section 213(d) medical expenses (except health insurance, long-term care services or insurance).
9. **Application of prohibition against deferred compensation to medical expenses - Certain advance payments for orthodontia permitted.** A cafeteria plan is permitted, but is not required, to reimburse employees for orthodontia services before the services are provided, but only to the extent that the employee has actually made the payments in advance of the orthodontia services in order to receive the services. These orthodontia services are deemed to be incurred when the employee makes the advance payment.

Reimbursing advance payments does not violate the prohibition against deferring compensation.

- 10. Application of prohibition against deferred compensation to medical expenses – Reimbursements for durable medical expenses:** A health FSA that reimburses a participant for medical equipment with a useful life extending beyond the period of coverage does not provide deferred compensation. A reimbursement for the purchase of a wheelchair is an example.
- 11. HDHP and Health FSA deductibles.** The deductible for a post-deductible health FSA need not be the same amount as the deductible for the HDHP, but in no event may the post-deductible health FSA or other coverage provide benefits before the minimum annual HDHP deductible under Code Section 223(c)(2)(A)(i) is satisfied (other than benefits permitted under a limited-purpose health FSA). In addition, although the deductibles of the HDHP and the other coverage may be satisfied independently by separate expenses, no benefits may be paid before the minimum annual deductible under Code Section 223(c)(2)(A)(i) has been satisfied. An individual covered by a post-deductible health FSA (if otherwise an eligible individual) is an eligible individual for the purpose of contributing to the HSA.
- 12. No effect on health FSA elections, coverage, use-or-lose rule:** A qualified HSA distribution does not alter an employee’s irrevocable election or constitute a change in status. If a qualified HSA distribution is made to an employee’s HSA, even if the balance in a health FSA is reduced to zero, the employee’s health FSA coverage continues to the end of the plan year. Unused benefits and contributions remaining at the end of a plan year (or at the end of a grace period, if applicable) must be forfeited.
- 13. Forfeitures:** Forfeitures from participants’ health and/or dependent care FSAs may be:
  - retained by the employer;
  - used to defray administrative expenses;
  - used to reduce salary reduction contributions for the next year on a “reasonable and uniform basis;” or
  - returned to employees on a “reasonable and uniform basis,” consistent with detailed requirements included in the proposed rules.

#### **1.125-6 Substantiation of expenses for all cafeteria plans**

- 1. When medical expenses are incurred:** Medical expenses are incurred when the employee (or the employee’s spouse or dependents) is provided with medical care and not when the employee is formally billed, charged for, or pays for the medical expense.

2. **Reimbursement of dependent care expense:** Dependent care expenses are incurred when the care is provided and not when the employee is formally billed, charged for, or pays for the dependent care.
3. **Dependent Care - Period of coverage:** For a dependent care assistance program eligible for the Code Section 129 exclusion to be offered through a cafeteria plan, it may not operate in a manner that enables employees to purchase dependent care assistance only for periods during which the employees expect to receive dependent care assistance. If the period of coverage for a dependent care assistance program offered through a cafeteria plan is twelve months (or, in the case of a short plan year, at least equal to the short plan year) and the plan does not permit an employee to elect specific amounts of coverage, reimbursement, or salary reduction for less than twelve months, the plan is deemed not to operate to enable employees to purchase coverage only for periods when dependent care assistance will be received.
4. **Dependent care - Optional spend-down provision:** At the employer's option, a cafeteria plan may provide that dependent care expenses incurred after the date an employee ceases participation in the cafeteria plan (for example, after termination) and through the last day of that plan year (or grace period immediately after that plan year) may be reimbursed from unused benefits, if all of the requirements of Code Section 129 are satisfied.
5. **All claims must be substantiated:** As a precondition of payment or reimbursement of expenses for qualified benefits, a cafeteria plan must require substantiation to comply. Substantiating only a percentage of claims, or substantiating only claims above a certain dollar amount, fails to comply with the substantiation requirements.
6. **Substantiation by independent third party:** All expenses must be substantiated by information from a third party that is independent of the employee and his or her dependents. The independent third party must provide information describing the service or the product, the date of the service or sale, and the amount. Self-substantiation or self-certification of an expense by an employee does not satisfy the requirements.
7. **Written statement from an independent third party:** The IRS will continue to accept information provided from an independent third-party (such as an "explanation of benefits" (EOB) from an insurance company) indicating the date of the Code section 213(d) medical care and the employee's responsibility for payment for that medical care (that is, coinsurance payments and amounts below the plan's deductible), and the employee certifies that any expense paid through the health FSA has not been reimbursed and that the employee will not seek reimbursement from any other plan covering health benefits, the claim is fully substantiated without the need for submission of a receipt by the employee or further review.
8. **Mandatory rules for all debit cards usable to pay or reimburse medical expenses:** The regulations follow the requirements of Revenue Rulings 2003-43 and Notice 2006-69. The regulations provide that an employer must limit use of the debit card to:

- (a) Physicians, dentists, vision care offices, hospitals, other medical care providers (as identified by the merchant category code);
- (b) Stores with the merchant category code for Drugstores and Pharmacies if, on a location by location basis, 90 percent of the store's gross receipts during the prior taxable year consisted of items which qualify as expenses for medical care described in Code Section 213(d); and
- (c) Stores that have implemented the inventory information approval system.

Comment: For health FSA debit card transactions occurring on or before December 31, 2007, all supermarkets, grocery stores, discount stores and wholesale clubs that do not have a medical care merchant category code are nevertheless deemed to be an "other medical provider" as described in Rev. Ruling 2003-43. During this time period, mail-order vendors and web-based vendors that sell prescription drugs are also deemed to be an "other medical provider" as described in Rev. Ruling. 2003-43. After December 31, 2008, health FSA debit cards may not be used at stores with the Drug Stores and Pharmacies merchant category code unless (1) the store participates in the inventory information approval system described in Notice 2006-69, or (2) on a store location by store location basis, 90 percent of the store's gross receipts during the prior taxable year consisted of items which qualify as expenses for medical care under Code Section 213(d).

### **1.125-7 Cafeteria plan nondiscrimination Rules**

- 1. Eligibility test - Reasonable classification:** A cafeteria will be deemed to be nondiscriminatory if the plan benefits a group of employees who are determined to be a reasonable classification. The classification will be deemed reasonable by the IRS if the plan satisfies the qualified retirement plan nondiscrimination classification test from the regulations under Code Section 410(b). This test is used in conjunction with the average benefits percentage test and for benefits, rights and features testing and certain tests for separate lines of business.
- 2. Eligibility test - Testing separately:** In performing the eligibility tests, those employees who have less than 3-years of service can be tested separately from those who have 3 or more years of service. Both groups must pass the test separately.
- 3. Contributions and benefits test:** To pass this test, a plan must give each similarly situated participant a uniform opportunity to elect qualified benefits, and the actual election of qualified benefits through the plan must not be disproportionate by highly compensated participants (while other participants elect permitted taxable benefits) (cash). Qualified benefits are disproportionately elected by highly compensated participants if the aggregate qualified benefits elected by highly compensated participants, measured as a percentage of the aggregate compensation of highly compensated participants, exceed the aggregate qualified benefits elected by non-highly compensated participants measured as a percentage of the aggregate compensation of non-highly compensated participants. A plan must also give each similarly situated participant a uniform election with respect to employer contributions, and the actual

election with respect to employer contributions for qualified benefits through the plan must not be disproportionate by highly compensated participants (while other participants elect to receive employer contributions as permitted taxable benefits). Employer contributions are disproportionately utilized by highly compensated participants if the aggregate contributions utilized by highly compensated participants, measured as a percentage of the aggregate compensation of highly compensated participants, exceed the aggregate contributions utilized by non-highly compensated participants measured as a percentage of the aggregate compensation of non-highly compensated participants.

3. **Safe harbor test for premium-only plans:** A premium-only plan is deemed to satisfy the nondiscrimination rules for a plan year if, for that plan year, the plan satisfies the safe harbor percentage test for eligibility, as discussed above.
4. **Time to perform nondiscrimination testing:** Nondiscrimination testing must be performed as of the last day of the plan year, taking into account all non-excludable employees (or former employees) who were employees on any day during the plan year.