Proposed Cafeteria Plan Regulations Are Consolidated and Updated

This Technical Bulletin is provided by the Employee Benefits and Executive Compensation Team of the law firm Drinker Biddle Gardner Carton.

Proposed cafeteria regulations published on August 6, 2007 consolidate and update a 23-year patchwork of proposed and temporary regulations, rulings and notices with respect to cafeteria plans. Previously issued final regulations about midyear election changes and coordination with the Family Medical Leave Act remain the same. The new proposed regulations address the cafeteria plan requirements for a written plan document, making and changing elections (other than permissible midyear changes), permissible benefits, flexible spending arrangements, substantiation of expenses and nondiscrimination rules.

Effective Dates. With two exceptions, the new regulations are expected to be generally effective for plan years beginning on and after January 1, 2009, but may be relied on for guidance until final regulations are issued. The effective date for previously issued debit card guidance is unchanged. A new rule for determining the taxable portion of group term life insurance coverage in excess of $50,000, as described below, is effective immediately.

Following is a summary of some of the key provisions and highlights from the new proposed cafeteria regulations.

GENERAL REQUIREMENTS

Definition of Cafeteria Plan. As under current law, the new proposed regulations require that a cafeteria plan provide a choice between at least one permitted taxable benefit (e.g., cash) and one qualified benefit. A plan that offers a choice only between nontaxable benefits or only between taxable benefits is not a cafeteria plan. A plan is also not a cafeteria plan if an employee has no choice. If the cafeteria plan requirements described below are met, giving employees the choice between taxable and nontaxable benefits will not, in itself, result in gross income to the employees.

Written Plan Document. A written plan document is required. The new proposed regulations specify that the written plan must be adopted and effective before the first day of the plan year to which it relates and the terms must apply uniformly to all participants. In addition to previous requirements, under these regulations the plan must contain certain rules relating to paid time off and flexible spending accounts ("FSAs") if those benefits are offered, to grace periods, if permitted, and to distributions from a health FSA to a Health Savings Account ("HSA"), if applicable. The plan document must also specifically limit participation to employees, as defined below.

Although the cafeteria plan must describe the benefits offered, the regulations allow this by incorporating by reference other plans describing the benefits. The proposed regulations also clarify that the written plan requirements for self-insured medical plans, dependent care plans and adoption assistance plans, may be satisfied in the cafeteria plan and that separate documents are not required.

Comment: Although the Code sections applicable to dependent care plans and adoption assistance plans, and the regulations that apply to self-insured medical plans refer to a separate written plan document, these regulations clarify that this requirement can be met through inclusion in a cafeteria plan document.

A cafeteria plan may be amended at any time as long as the amendment is not effective until the later of the adoption date or the effective date of the amendment. If a new benefit is added, payment or reimbursement of expenses for the benefit is only permitted after the later of the adoption date or the effective date.

The plan year must be 12 months. A shorter plan year, including a change in plan year shorter than 12 months, is permitted only for a valid business reason.
Employees. As under current law, only employees (including former employees, if the plan is not predominately for their benefit) may participate in a cafeteria plan. Leased employees and full-time life insurance salespeople are eligible, but self-employed individuals and two-percent shareholders of an S corporation are not. Sole proprietors, partnerships and S corporations may sponsor cafeteria plans, but only employees may participate. An individual who is both an employee and an independent contractor, for example, may participate only in his or her capacity as an employee.

Although a cafeteria plan may provide benefits to spouses and dependents of participants, spouses and dependents may not participate (i.e., may not make elections for benefits under the plan). A spouse does not become a participant even if, upon the death of a participant, the spouse may elect a settlement or distribution with respect to the deceased employee's benefits offered through the cafeteria plan, such as an HSA or group term life insurance.

Elections. As provided under the prior proposed regulations, elections must be made before the earlier of the beginning of the plan year (or other coverage period) or the date the taxable benefits would be currently available. The new proposed regulations allow new employees who are eligible on their date of hire to make an election within 30 days of their hire date. Although the election is effective on the date of hire, salary reductions must be made from compensation not yet available as of the date of election. The regulations also provide that employees rehired within 30 days or on an unpaid leave of less than 30 days are not considered new employees for purposes of this election.

The new proposed regulations specifically permit elections to be made electronically and apply the safe harbor regulations under the Code for use of electronic means. Automatic enrollment with default elections of nontaxable benefits is permitted for both initial and open enrollment elections with adequate advance notice and the opportunity to elect cash.

Comment: The examples in prior guidance and the proposed regulations specify that a notice to a current employee must include a description of the employee’s existing coverage, if any.

Employers will want to consider this in deciding whether to provide continuation of nontaxable benefits as a default.

Midyear changes in elections are permitted in the final cafeteria plan regulations previously issued. The proposed regulations, however, add an additional rule regarding HSA contributions made through a cafeteria plan. HSA contributions may be changed prospectively on at least a monthly basis and may be revoked if the employee becomes ineligible to make HSA contributions.

QUALIFIED, TAXABLE AND NONQUALIFIED BENEFITS

Cafeteria plans must offer a choice between qualified benefits and permitted taxable benefits.

Taxable Benefits. Cash and certain other benefits treated as cash are permitted taxable benefits for purposes of the cafeteria plan rules. Besides cash compensation, cash includes payments for annual leave, sick leave and other paid time off, severance pay, property, and benefits attributable to employer contributions that are taxable upon receipt by the employee. In addition, benefits offered under a cafeteria plan purchased, or treated as purchased, with after-tax employee contributions are also treated as cash. For example, an employee receiving long-term disability coverage can be treated as receiving cash equal to the value of the coverage that is then used to purchase the coverage.

Although severance pay is considered cash and, thus, a permitted taxable benefit, distributions from a qualified pension plan are not cash for purposes of cafeteria plan elections.

The new proposed regulations specifically provide that a cafeteria plan may permit, as a taxable benefit, the election of group health coverage for an individual who is not the spouse or dependent of the employee.

Comment: Employees may now elect and pay for coverage for a domestic partner or former spouse through the cafeteria plan. The fair market value of such coverage will be taxable to the employee.
Qualified Benefits. In general, qualified benefits are those excludable from income under a specific section of the Code and which, except as specifically otherwise permitted under Code section 125, do not defer compensation. Qualified benefits include those under the prior proposed regulations: group term life insurance that provides no permanent benefits; employer-provided group health plans, including health FSAs, and accidental death and dismemberment benefits; dependent care assistance; and contributions to 401(k) plans. Since the prior regulations were issued, the following have been added: adoption assistance; HSAs; and certain post-retirement group life insurance plans maintained by educational organizations. It must be remembered, however, that the nondiscrimination rules of the specific Code sections governing each benefit must be met for the benefit to be excludible from gross income. (The nondiscrimination rules applicable to cafeteria plans are discussed later in this Technical Bulletin.)

The regulations also provide some new rules. The qualified status of group term life insurance over $50,000 is continued, but determination of the taxable amount is revised. Under current guidance, the taxable amount is the greater of the Table 1 cost of the coverage exceeding $50,000 (the "excess coverage") or the employee’s salary reduction contributions plus employer contributions for the excess coverage. The new proposed regulations provide that the amount includible in income is the Table 1 cost of the excess coverage minus all after-tax contributions made by the employee for the group term life coverage.

COBRA premiums for an employer-provided group health plan are qualified benefits if they are excludable from the employee’s income or if they are related to the group health plan of the employer sponsoring the cafeteria plan, even if the fair market value of the premiums are includible in an employee’s gross income.

Comment: This permits the employee to pay COBRA premiums through the cafeteria plan for someone other than a spouse or dependent.

The proposed regulations also provide that the payment or reimbursement (other than through an FSA) of employees’ individual health insurance premiums is a qualified benefit if the amounts are substantiated by the employer (e.g. the employee submits a receipt from the insurer).

A benefit is not qualified if it defers compensation, except as specifically permitted under Code section 125 (e.g., contributions to a 401(k) plan, HSAs, certain post-retirement group term life plans of educational organizations or amounts available during a grace period as provided below). Thus, if a cafeteria plan offers paid time off, it must also preclude the possibility of using the paid time off or receiving a cash-out of the time in a future year. To avoid a prohibited deferral, the regulations require that non-elective paid time off be used before elective time off. Any unused amount must be cashed out before the end of the year or be forfeited. The grace period rules do not apply to paid time off.

The regulations do provide, however, that certain features or benefits do not violate the prohibition against deferred compensation:

- Credit toward the deductible for unreimbursed covered expenses
incurred in prior periods, reasonable lifetime maximum limit on benefits, level premiums, premium waiver during disability, guaranteed policy renewability of coverage (without further evidence of insurability but not a guaranty of the amount of premium upon renewal), coverage for specified accidental injury, coverage for a specified disease or illness or payment of a fixed amount per day of hospitalization.

- Benefits under a long-term disability policy relating to more than one year.
- Reasonable premium rebates or policy dividends if paid within the 12-month period following the cafeteria plan year to which they relate.
- Mandatory two-year election for vision or dental insurance, if premiums are paid at least annually and the plan does not use salary reduction or flex credits relating to the first year for the second year.
- Salary reduction amounts from the last month of one plan year may be applied to pay accident and health insurance premiums for the first month of the immediately following plan year, if done on a uniform and consistent basis.

For the features described in the first bullet above: (i) no part of any benefit can be used to purchase a benefit in a future plan year; (ii) the policies can remain in force only as long as premiums are timely paid and if current premiums are not paid, all coverage for new diseases or illnesses must lapse (except for premium waiver during disability); (iii) there must be no investment fund or cash value to rely upon for premium payment; and (iv) no part of any premium may be held in a separate account for any participant or beneficiary or otherwise segregated from the insurer’s assets.

**Nonqualified Benefits.** In general, the following benefits are not permitted under a cafeteria plan: scholarships; employer-provided meals and lodging; educational assistance; fringe benefits; long-term care insurance; long-term care services; group term life insurance on the life of any individual other than the employee; health reimbursement arrangements (if they cap the reimbursements and unused amounts may be carried forward to raise the cap in subsequent periods); contributions to Archer Medical Savings Accounts; and elective deferrals to section 403(b) plans.

**FLEXIBLE SPENDING ACCOUNTS**

**Qualified Benefits Under an FSA.** Dependent care assistance, adoption assistance and medical reimbursement arrangements may be offered through an FSA in a cafeteria plan. Any qualified benefits offered through a cafeteria plan must satisfy the nondiscrimination requirements under the Code for those benefits.

A health FSA is not permitted to reimburse employees for payments for other health plan coverage, including premiums for COBRA coverage, accidental death and dismemberment insurance, long-term or short-term disability insurance or for the premiums for health coverage under an employer health plan of the employee, the employees’ spouse or dependents. A health FSA cannot be used to reimburse expenses for long term care insurance premiums or services for the employee, the employee’s spouse or dependents.

**Uniform Coverage Rule.** The proposed regulations preserve the requirement of uniform coverage throughout the period that applies only to health FSAs. Under this rule:

- The maximum amount of reimbursement from a health FSA must be available at all times during the period of coverage (less any prior reimbursements for the same period) and cannot relate to the amount that has been contributed at a particular time before the end of the plan year.
- Required contributions under a health FSA may not be based on the amount of claims incurred during the period and employees’ salary reduction contributions may not be accelerated based on the employees’ incurred claims and reimbursements.

**Use-It or Lose-It Rule.** The “Use-It or Lose-It Rule” remains intact under the new proposed regulations. Unused contributions remaining at the end of a plan year (or grace period, if applicable) must be forfeited.

Once the period of coverage has begun under an FSA, an employee must not be able to receive reimbursements from one type of FSA for expenses attributable to other qualified benefits.
Arrangements formally outside of the cafeteria plan to adjust an employee’s compensation on the basis of reimbursements received are considered in determining compliance of a cafeteria plan with the Use-It or Lose-It Rule.

**Grace Period.** The new proposed cafeteria plan regulations incorporate previous guidance on the use of grace periods in cafeteria plans. Under the proposed regulations, a cafeteria plan may include a grace period of up to two and a half months after the end of each plan year. With a grace period, an employee who has unused contributions for a specific qualified benefit, such as a health care FSA, after the end of the plan year may be reimbursed from the unused contributions for expenses incurred during the grace period. The effect of the grace period is to give an employee as long as 14 months and 15 days to use his or her contributions made in a plan year.

**Optional features.** A grace period may:

(i) apply to some qualified benefits but not to others;

(ii) limit the amount of unused contributions available during the grace period, as long as the limit applies uniformly to all participants and is not based on a percentage of unused contributions remaining at the end of the prior plan year;

(iii) be less than two and one half months; and

(iv) first apply unused contributions from the prior year to reimburse grace period expenses and then reimburse the grace period expenses from current year contributions.

**Required provisions.** A grace period provision must:

(i) apply uniformly to all participants in the cafeteria plan as of the last day of the plan year, including COBRA participants and participants who terminate during the grace period;

(ii) limit reimbursement of unused contributions for a specific qualified benefit to expenses for the same benefit (i.e., unused health FSA contributions may not be used to reimburse dependent care expenses); and

(iii) require forfeiture of unused contributions from the preceding plan year that exceed the expenses incurred during the grace period.

**Run-out Period.** Consistent with existing guidance, a cafeteria plan may use a run-out period after the end of the plan year (or grace period) during which a participant can submit claims for reimbursement for expenses incurred during the plan year (or grace period) as long as the run-out period is provided on a uniform and consistent basis for all participants.

**HSA-Compatible FSAs.** The proposed regulations reflect interim guidance the IRS has issued on HSAs and confirm that limited-purpose health FSAs and post-deductible health FSAs may be offered through a cafeteria plan. An individual covered by a general purpose health FSA is not eligible to contribute to an HSA. However, an employee who is covered by a high deductible health plan (an “HDHP”) will be eligible for an HSA if he or she is also covered by a limited-purpose health FSA or post-deductible health FSA.

- A limited-purpose health FSA is a health FSA that only reimburses permitted coverage benefits, such as vision, dental or preventive care.
- A post-deductible health FSA is a health FSA that only reimburses medical expenses for preventive care or medical expenses incurred after the minimum annual HDHP deductible is satisfied.
- A combination of a limited-purpose health FSA and a post-deductible health FSA may be used.

**Qualified HSA Distributions.** The proposed regulations reflect recent guidance on direct rollover distributions from an employee’s health care FSA to his or her HSA. Such a distribution is allowed if:

- No qualified HSA distribution has been previously made on behalf of the employee from this health FSA;
- The employee elects to have the employer make a qualified HSA distribution from the health FSA to the HSA of the employee;
- The distribution does not exceed the lesser of the balance of the health FSA, determined on a cash basis, on the date of the distribution, or the balance on 9/21/06, provided that the distribution is made no later than December 31, 2011; and
- The employer makes the distribution directly to the trustee of the employee’s HSA.
“Under the new proposed regulations, the responsibility for making sure that expenses are substantiated before being paid or reimbursed rests with the plan sponsor.”

Expense Substantiation. Under the new proposed regulations, a cafeteria plan generally may pay or reimburse only those expenses that are: (1) properly substantiated, (2) incurred on or after the date the employee enrolls in the particular qualified benefit under the cafeteria plan, and (3) incurred during the time the participant was covered by the particular benefit. The new proposed regulations contain a new exception to this general rule whereby an employer may permit dependent care expenses incurred between the date the employee terminates participation in the dependent care FSA (i.e., at termination of employment) and the end of the plan year (plus any grace period) to be reimbursed from any unused contributions from that year. Please note, this rule, referred to as the “optional spend down provision,” must be incorporated in the written cafeteria plan document and does not apply to a health FSA.

Under the new proposed regulations, the responsibility for making sure that expenses are substantiated before being paid or reimbursed rests with the plan sponsor. The new proposed regulations confirm that existing law continues to apply, providing that: (1) all expenses must be substantiated, and the practice of substantiating only claims more than a certain dollar limit or a representative sample of claims will not be sufficient, (2) the special rules for automatically substantiating co-pays (including multiple co-pays up to five), real-time point of service transactions (i.e., picking up a prescription at a pharmacy) and recurring medical expenses continue to apply, (3) an expense is incurred when the service is provided (not when it is billed, charged or paid), and (4) reimbursement or payment of expenses is allowed to be made at a later date (even after the coverage period ends). The new proposed regulations also adopt the category of automatic substantiation for expenses incurred at a merchant that participates in the “inventory approval system” described in IRS Notice 2006-69 (whereby the merchants are able to verify which purchases are medical expenses through the use of stock keeping unit (SKU) codes on the packaging). To the extent applicable, the same general substantiation rules apply to the payment or reimbursement of health care, dependent care and adoption assistance expenses.

Debit Card Use. Debit cards have become a very popular feature in many health and dependent care FSAs. The new proposed regulations provide detailed rules allowing health and dependent care FSAs to reimburse or pay qualifying expenses via a debit card. The debit card substantiation rules generally follow existing IRS guidance. Specific requirements in the new proposed regulations include:

1. the employee must agree in writing to (i) only use the debit card for approved medical expenses, (ii) not use the debit card for expenses that have already been reimbursed, (iii) not seek reimbursement elsewhere, and (iv) keep sufficient documentation (i.e., invoices, receipts);
2. the debit card must include a statement (generally on the back of the card) that the above conditions apply each time the card is used;
3. the amount available on the debit card must be limited to the amount of the employee’s FSA balance;
4. the debit card must be canceled automatically when the employee stops participating in the FSA;
5. the debit card must be used only for: (i) medical care providers (i.e., physicians, hospitals, etc.), (ii) nonmedical care merchants (i.e., drug stores, supermarkets, etc.) that participate in the “inventory approval system” described above, or (iii) certain other drug stores or pharmacies (if, during the prior year, 90% of the gross receipts for that store location consisted of items qualifying as medical expenses under IRC Sec. 213(d));

6. the claims must be substantiated in accordance with the rules in the new proposed regulations; and

7. the correction procedures outlined in the new proposed regulations must be used to correct improper reimbursements or payments made with the debit card.

These new proposed regulations also explain how a debit card is used to pay or reimburse dependent care FSA expenses. These rules are similar to those for health FSAs, except that: (i) dependent care expense reimbursements are limited to the amount actually in the participant’s dependent care FSA, and (ii) dependent care expenses may not be reimbursed before the expenses are incurred (this affects the timing of when a prepayment to a dependent care provider can be reimbursed).

**Nondiscrimination Requirements**

The new proposed regulations consolidate previous guidance issued on nondiscrimination testing of cafeteria plans. Consistent with Code Section 125, a cafeteria plan may not discriminate in favor of highly compensated individuals as to eligibility or in favor of highly compensated participants as to contributions and benefits. In addition, the nontaxable benefits provided to key employees cannot exceed 25% of nontaxable benefits provided to all employees under the plan. Discriminatory benefits are included in the gross income of the affected employees.

The regulations include new definitions for several key terms used in testing, provide new guidance on eligibility requirements by incorporating some of the qualified plan rules for coverage testing, provide a new objective test to determine when the actual election of benefits is discriminatory and create a safe harbor for certain premium-only plans.

**Eligibility.** Under the eligibility test for a cafeteria plan: (1) the classification of eligible employees must be reasonable; and (2) the eligible group must pass either the safe harbor or facts and circumstances test applied to qualified retirement plans. For purposes of the test, the plan may exclude employees (except key employees) who are covered by a collectively bargained plan, nonresident aliens who receive no income from sources within the United States, and employees participating under COBRA continuation. A plan cannot impose a waiting period of more than three years of employment for participation and the waiting period must be the same for all employees. If the waiting period is less than three years, then all employees must be included in applying the eligibility test.

The proposed regulations define certain key terms, including highly compensated individual or participant, key employee, officer and compensation. For cafeteria plan testing, a “highly compensated individual” is an officer, a five percent shareholder, or an employee who received compensation over $100,000 (indexed for inflation) the preceding plan year (or the current plan year in case of the employee’s first year of employment). A “highly compensated participant” is a highly compensated individual who is eligible to participate in the cafeteria plan. The regulations define “key employee” using the qualified retirement plan rules, and apply a facts and circumstances test to determine if an individual is an officer, considering the source of the individual’s authority, the term of his or her appointment, and the nature and extent of his or her duties.

**Contributions and Benefits.** A cafeteria plan must (i) give each similarly situated participant a uniform opportunity to elect qualified benefits, and (ii) highly compensated participants must not elect benefits under the plan at a disproportionate rate compared to non-highly compensated participants. The benefits elected by highly compensated participants are measured as a percentage of the aggregate compensation of the highly compensated participants and cannot exceed the benefits elected by non-highly compensated participants, measured as a percentage of their aggregate compensation.

A cafeteria plan must give each similarly situated participant a uniform opportunity to elect any employer contributions and the actual election of...
employer contributions may not disproportionately favor highly compensated participants. The aggregate employer contributions for highly compensated participants are measured as a percentage of their aggregate compensation and may not exceed the aggregate contributions utilized by non-highly compensated participants, measured as a percentage of their aggregate compensation.

Comment: The new nondiscrimination tests for contributions and benefits are significantly more burdensome than the existing cafeteria plan rules. The new rules are similar to the nondiscrimination tests applied to 401(k) plans and may limit highly compensated individuals’ use of these programs.

Safe Harbor for Plans Providing Health Benefits. The new proposed regulations outline a safe harbor test to satisfy the benefits and contributions nondiscrimination requirement for a plan that provides health benefits limited to major medical coverage and excluding dental coverage and health flexible spending accounts. The safe harbor is satisfied if contributions under the plan for each participant include an amount which either: (1) equals the cost of the health benefits selected by the majority of similarly situated highly compensated participants; or (2) is at least 75% of the cost of the highest cost health benefits selected by any similarly situated participants. The contributions or benefits under the plan above the safe harbor must be proportionate to participants’ compensation.

Safe Harbor for Premium-Only Plans. The regulations provide a safe harbor for a plan that offers only an election between cash and pre-tax payment of the employee’s share of the employer-provided accident and health insurance premium. The premium-only plan will satisfy the safe harbor if: (1) it benefits a classification of employees that is found by the IRS not to discriminate in favor of highly compensated participants; (2) no employee is required to complete more than three years of service to participate; and (3) each employee can participate in the plan the first day of the plan year after meeting the service requirement.

Permissive Disaggregation and Permissive Aggregation. A cafeteria plan that benefits employees who have not completed three years of service may test for nondiscrimination as if the plan were two separate plans, i.e., one plan for employees who have completed three years of employment and another plan for employees who have less than three years of employment. However, if the plan is disaggregated, then the two separate plans must be tested separately for both the eligibility test and the contributions and benefits test.

Alternatively, if an employer sponsors more than one cafeteria plan, the employer may aggregate the plans for purposes of nondiscrimination testing. If the employer chooses to aggregate the plans, the combined plan must satisfy the eligibility and the contributions and benefits tests as if it were a single plan.

Administrative Details. The proposed regulations clarify that 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. If a cafeteria plan is discriminatory, a highly compensated participant or key employee participating in the plan must include in gross income the value of the taxable benefit with the greatest value that the employee could have elected. The proposed regulations also clarify that employer contributions to employees’ HSAs through a cafeteria plan are subject to the cafeteria plan nondiscrimination rules and not the comparability rules that otherwise apply to HSAs.

The intent of this Technical Bulletin is to provide general information on employee benefit issues. It should not be construed as legal advice and, as with any interpretation of law, plan sponsors should seek proper legal advice for application of these rules to their plans. © 2007 Gallagher Benefit Services