

BenAlert

Benefit Trends and Legislative Updates



October 2007

Howitt Insurance Services is pleased to provide you with periodic updates on benefit trends and legislative updates. As part of our valuable services, we want to ensure that you are in compliance and well-informed of the ongoing changes in our industry.

New Proposed Cafeteria Plan Rules

October 2, 2007

On August 6, 2007 the Internal Revenue Service (IRS) published a new set of proposed regulations which replace and incorporate much of the previously published IRS guidance for the establishment and administration of Internal Revenue Code (IRC) Section 125 plans. The comment period on these proposed regulations ends on November 5, 2007. Although we expect there will be minor changes as a result of public comment, these new regulations will take effect for plan years beginning on or after January 1, 2009.

The purpose of this legislative update is to highlight the key provisions of these new proposed regulations (the new proposed rules) that will directly affect plan sponsors in the administration of their cafeteria plans. It is not intended as a comprehensive restatement of the new proposed rules. If you wish to see the complete version of the new proposed rules go to:

http://www.regulations.gov/fdmspublic/component/main?main=DocumentDetail&d=IRS_FRDOC_0001-0103.

Background

1. A Little Tax History. Congress enacted IRC Section 125 in 1978 to carve out an exception to the constructive receipt doctrine that pervades the IRC. In brief, if you can receive cash as an option to a non-taxable item, the IRC will treat your choice as income, regardless of your choice. Section 125 allows the choice between cash and a “qualified employee benefit” to be treated as non-taxable if you elect the benefit. The result of this exception is that IRS rules are strict and offer burdensome compliance hurdles such as a written plan document and irrevocable elections which must be made before the beginning of the plan year. All of these requirements remain in the new proposed rules. A 125 plan must follow all the cafeteria plan rules or the IRS will disqualify the plan.

2. What the New Proposed Rules Encompass. The IRS drafters retained the contents of the earlier regulations and incorporated numerous IRS notices such as the 2-1/2 month extension, the negative initial enrollment, debit card rules, and the HSA rollover rules into the new proposed rules.

3. The New Proposed Rules Format. The new proposed rules keep some of the same numbering (1.125-1, etc.) but has reorganized their content:

- 1.125-1 General Operating Rules
- 1.125-2 Participant Election Rules
- 1.125-5 Flexible Spending Arrangement Rules
- 1.125-6 Substantiation Rules
- 1.125-7 Nondiscrimination Rules

Reg. Sections 1.125-3 (FMLA rules) and 1.125-4 (change in status rules) remain in effect.

4. Cafeteria Plan Defined. A cafeteria plan must allow an employee to choose between cash and nontaxable benefits. If the plan only allows the employees to choose among non-taxable benefits, then it is *not* a cafeteria plan and the employee contribution, if there is one, must be made from after-tax dollars. Generally, there are three types of cafeteria plans:

- **Premium Contribution Plan.** This type of plan allows the employee to choose between salary and payment of premiums for qualified benefits (medical, dental, vision, etc.) on a pre-tax basis. This type of plan is a financing device and not subject to the Employee Retirement Income Security Act of 1974 (ERISA).
- **Flexible Benefit Plan.** This type of plan ordinarily contains a premium contribution account, a healthcare spending account, and a dependent expense account. Employees elect to pay the necessary premium contributions on a pre-tax basis and then elect to fund for future health care expenses and/or dependent care expenses (e.g., daycare) on a pre-tax basis.
- **Flexible Spending Accounts Using Flex Credits.** Under this type of plan, the plan sponsor provides credits that employees can allocate to the accounts (premium, health care spending account, and dependent expense care account) as well as make additional pre-tax contributions to these accounts. The unused credits must be available as cash under most circumstances.

Needless to say, a cafeteria plan has numerous other compliance requirements to be considered a cafeteria plan. The new proposed rules have retained them all. In this memorandum we discuss only a selected number of these requirements.

5. The Effective Date. The new proposed rules will take effect as final regulations for plan years beginning on or after January 1, 2009. Plan sponsors may follow the new proposed rules in the meantime. We recommend generally that plan sponsors adopt the new proposed rules as soon as practicable to take advantage of the clarity of the new proposed rules.

1.125-1: General Operating Rules

1. The Plan Document. As in the past, the written plan document must be adopted and in place before the first day of the plan year to which it applies. This contains a complete description of the necessary contents of the plan document. If the documents are not in place before the beginning of the plan year or are incomplete, the IRS will disqualify the plan.

2. Amending the Plan. The plan sponsor may amend the plan at any time. However, the amendment must take effect on the later of the date it is adopted or its effective date. In other words, plan sponsors may not amend the plan retroactively, as may have been a prior practice to cure plan defects.

3. Domestic Partner Benefits. According to this new proposed rule, employees may now elect coverage for domestic partners. This is a significant change. For federal income tax purposes, the plan sponsor must report the full fair market value of the coverage for the domestic partner as imputed income to the employee.

4. Qualified Benefits. The new proposed rules also liberalize the definition of qualified benefits:

- The new rules will allow the inclusion of group term life insurance over \$50,000 so long as the employer imputes income on the effected amounts using the Table I rates. As you will note below, dependent life coverage is *not* a qualified benefit under a cafeteria plan.
- Premiums for an employee's COBRA coverage under the health plan of the cafeteria plan sponsor or a former employer's plan can be a qualified benefit. The employer may also allow employees to make after tax contributions toward a former spouse's COBRA premium.
- Paid time off benefit (e.g., vacation, sick leave, and personal days) are qualified benefits but if paid in cash, the employee must receive it before the end of the plan year.
- The following are *not* qualified benefits:
 - Educational assistance;
 - Transportation plans;
 - Long-term care plans;
 - Archer medical savings account contributions;
 - Cash Value or dependent life plans; and
 - Contributions to any deferred compensation plan with the exception of a 401(k).

Educational assistance and transportation plans allow pre-tax contributions outside a 125 plan, pursuant to their own rules.

5. Optional Grace Period. The new proposed rules incorporate the optional 2-1/2 month grace period provisions; however, if adopted, it will not apply to paid time off or 401(k) contributions.

6. Dental Benefits. In recognition of current underwriting practices, the new proposed rules will permit the plan to require a two year election for dental or vision benefits. Similarly, if a provider requires pre-payment of orthodontia services (over a two year period, for example) the plan can treat these pre-payment as a part of a qualified benefit. It will not be treated as deferred compensation.

7. Individual Policy Premiums. The new proposed rules, as is consistent with Rev. Ruling 61-146, will allow tax free reimbursement of employee's substantiated premium expense for the employee's individual or family health policy but not for the individual policy issued to the non-employee family member. The 125 plan sponsor

can make a direct reimbursement or issue a check to the employee in the name of the carrier, or in the name of both the employee and carrier. This will allow states to mandate premium only plans as a part of health reform.

8. Dependent Definition. For purposes of cafeteria plans, the definition of dependent is to be the same definition permitted by the IRC section applicable to the underlying benefit. The health FSA, for example, is a benefit under IRC Section 105. Following the passage of the EGTRRA in 2004, which modified the dependent definition found at IRC Section 152, the IRS issued informal guidance allowing plan sponsors to ignore the earnings limitation when determining dependent status. The new proposed rules, by using the IRC 105 definition, relieve plan sponsors from applying the earnings limitation, thus allowing for the broader definition. Additionally, the new proposed rules permit plans to include spouses and dependents of former and deceased employees to be eligible for cafeteria plan benefits. The new proposed rules do not address the potential loss of a dependent's tax exemption as of the first day of the year in which a dependent turns age 24.

9. Short Plan Years. The new proposed rules require that a plan sponsor have a valid business purpose for creating a short plan year (e.g., change in health plan policy year, acquisitions, etc.). The rules will prohibit the implementation of the short plan year if the purpose is to circumvent cafeteria plan rules.

1.125-2: Elections

1. New Hire Elections. This regulation allows employees who are eligible on date of hire to make an election within 30 days of that date to be effective as of date of hire. Contributions must come out of compensation earned after the election. This rule does not apply to a former employee, without coverage, who is rehired within 30 days or an employee without coverage returning from a leave of absence.

2. HSA Elections. HSA elections can be monthly on a prospective basis and revoked if the employee ceases to be eligible to make HSA contributions (e.g., no longer covered by a high deductible health plan).

3. Default Elections. The regulation incorporates Rev. Ruling 2002-27 permitting automatic enrollment in the premium contribution plan account so long as there is adequate notice and an opportunity to opt out.

4. Electronic Elections. Employees may make electronic elections so long as they meet the electronic safe harbor rules.

5. Revocation of Elections. The plan may allow employees to revoke elections so long as the basis for the revocation meets the change in status requirements included in Reg. Section 1.125-4 and the revocation / election is consistent with the status change. The new proposed regulations omit the option of permitting participation to cease by the mere cessation of contributions absent a change in status.

6. Valid Elections. Only employees can make valid elections or revocations.

1.125-5 Flexible Spending Arrangement

1. Qualified Benefits Under Flexible Spending Arrangement. In addition to health care spending accounts and dependent care accounts, flexible spending accounts also may include adoption assistance benefits. The full amount of the election under a health care expense account must be available throughout the plan year (uniform coverage rule unchanged). Dependent care and adoption assistance benefits are payable to the extent they have been funded.

2. Health Care Expense Accounts. This regulation clarifies that expenses are incurred at the time the services are provided, not when billed or paid. Additionally, the new rules make it clear that a health care expense account can limit covered expenses to any subset of IRC Section 213 expenses. This regulation not only provides for the limited purpose FSA requirements for employees who maintain an HSA, but also allows a plan sponsor to limit reimbursements to medical only, and the like.

3. Eligibility. An FSA plan sponsor may also limit participation in a FSA account to those who participate in one or more specific accident or health plans. It would appear to permit an FSA to be available to a PPO plan and not an HMO as long as the FSA does not violate the applicable non-discrimination rules under IRC Section 125 or 105(h).

4. HSA Distributions. This regulation restates the recently announced rules which permit an employee to rollover unused health care FSA contributions to an HSA. This regulation liberalizes the original Notice 2007-22 rules by permitting the rollover at anytime during the year rather than the end of the year, as long as the FSA plan document has been amended to permit the rollovers and to establish the limited purpose plan option. To be eligible to conduct a rollover, the employee must have been participating in an FSA on September 21, 2006 and must exercise the rollover before September 30, 2011.

5. Forfeitures. The new proposed rules retain the ability of the plan sponsor to keep forfeitures generated under the FSA accounts. The sponsor may also use the forfeitures:

- To defray plan administrative expenses;
- To allocate the forfeitures in a reasonable and uniform way to plan participants; and,
- To make non-elective uniform contributions to FSA accounts in the next plan year.

This rule does not appear to permit cash distributions, a departure from the old rules.

1.125-6 Substantiation of Expenses

1. Each Claim must be Substantiated. The proposed new rules for substantiation apply to all FSA accounts and generally parallel the IRS guidance for debit cards (Rev. Rul. 2003-43, Notice 2006-69, and Notice 2007-2):

- All claims must have substantiation regardless of size. Sampling is not allowed. The rules prohibit limitations such as only claims over \$50 are to be substantiated;
- The substantiation must occur before the claim can be paid. Advance payments are prohibited; and,
- The new rules permit automatic substantiation for co-pays, certain point of service transactions with real time verification, recurring medical expenses, and for expenses incurred at merchants using IIAS codes.

2. Dependent Care Expenses. A dependent care FSA may allow dependent care expenses incurred after the employee terminates for the remainder of the plan year up to the funded account balance. Reimbursement must occur only after the expense is actually incurred, not just billed.

3. Debit Cards. The new proposed rules contain a restatement of IRS guidance on the requirements necessary for their use. Please refer to our previous legislative updates for details (2006-7 and 2007-5). It is also worth noting that the new rules verify that the card may be made available to COBRA continues.

1.125-7 Non-discrimination Rules

- 1. Overview.** In general terms, the IRS has provided clarity to the discrimination testing requirements under cafeteria plans. Historically, practitioners who perform discrimination tests for these plans have used contribution and benefit tests without the benefit of IRS guidance. This regulation provides an objective benefits test. It also provides a safe harbor test for premium contribution plans. We expect the IRS will receive numerous comments on these rules. As a result, final regulations may provide additional guidance on testing.
- 2. Premium Only Plan Safe Harbor Test.** Section 1.125-7 contains a safe harbor benefits and contribution test for POP plans. A safe harbor will exist if both the highly and non-highly compensated employees are offered the same benefits (e.g., one medical plan) for precisely the same cost (i.e., employee contribution). It doesn't matter that more highly compensated employees than non-highly compensated employees are covered by the plan. The plan still must pass the POP eligibility test.
- 3. Official Testing Date.** The new proposed rules require testing on the last day of the plan year and require that the testing include all non-excludable employees (or former employees) who were employees on any day during the plan year. To assure compliance with the testing requirements, plan sponsors will need to test informally prior to the end of the plan year. The end-of-year test will be the official test for purposes of compliance. We presume that plans may adjust the non-taxable maximum contribution for highly compensated individuals during the plan year as needed to achieve compliance.
- 4. Reasonable Classification Test.** The new rules indicate that plan sponsors may conduct a cafeteria plan's eligibility test by using the reasonable classification / safe harbor test set forth in IRC Section 410(b), a generally accepted testing practice at the present time.

This legislative update, albeit somewhat technical, only provides you with a limited view of the new proposed rules. It is important that you seek the advice of your benefits consultant or your benefits counsel. You will want to avoid the financial impact of maintaining a disqualified plan.

We will provide additional update on the new proposed rules as they occur.

This legislative update is published as an information source by Howitt Insurance Services (HIS). We are not an attorney firm and HIS is not giving legal advice or interpreting the legal code for our clients and colleagues. It is general in its nature and is no substitute for legal advice or opinion in any particular case.