Employee Benefits Alert

KEY POINTS

#1
THE DETAILS MATTER
The new rules require more detail in your Section 125 plan document.

#2
CLARIFICATION OF THE NONDISCRIMINATION RULES
The new rules clarify the non-discrimination rules. The rules are now closer to the non-discrimination rules used for retirement plans.

#3
2009 EFFECTIVE DATE
The new rules are effective for plan years beginning on or after January 1, 2009, but you can rely on them immediately.

To Our Clients And Friends

IRS Issues New Cafeteria Plan Regulations

On August 3, 2007, the IRS released new proposed regulations on cafeteria plans under Section 125 of the Internal Revenue Code ("Section 125"). This new set of proposed rules replaces five sets of proposed rules issued between 1984 and 2000, and consolidates the IRS' guidance on a range of cafeteria plan issues. For the most part, the rules will take effect for plan years beginning on or after January 1, 2009, but employers may begin relying on the new rules immediately. The new proposed regulations are designed to be comprehensive and reiterate what the IRS has previously stated, but there are some new requirements and renewed emphasis on some areas.

Overall Plan Requirements

The new rules clarify that Section 125 is the exclusive means by which an employer may offer employees a choice between taxable and nontaxable benefits, without that choice resulting in the inclusion of the benefits in the employee's gross income. The new rules also emphasize that unless a plan complies with the requirements of Section 125 and the regulations, the plan is not a cafeteria plan. A plan could fail to satisfy Section 125 by:

- offering nonqualified benefits;
- failing to offer a choice between at least one permitted taxable benefit (such as cash) and at least one qualified (nontaxable) benefit;
- deferring compensation;
- failing to comply with the uniform coverage or use-it-or-lose it rules for flexible spending accounts ("FSAs");
- allowing employees to revoke or make new elections during a plan year other than on account of a permitted status change;
- failing to comply with the claims substantiation requirements;
- paying or reimbursing expenses for benefits incurred before the plan's effective date or before a period of coverage begins;
- allocating experience gains (formerly called forfeitures), except as permitted by the new rules; or
- failing to comply with the grace period rules.

A cafeteria plan's failure to satisfy Section 125 means that all benefits provided to the employee, both taxable and nontaxable, are included in the employee's gross income.

Only employees are eligible to participate in Section 125 plans. This includes leased employees and former employees, but not sole proprietors, partners or directors (if not common law employees). Also, while a Section 125 plan may include former employees, it cannot be maintained predominately for former employees.

Qualified/Nonqualified Benefits

To be a qualified benefit, the benefit must be excludable from the employee's gross income under a specific provision of the Internal Revenue Code and must not defer compensation. The new rules also provide guidance on when certain benefit practices do and do not serve to defer compensation.

Among the qualified benefits provided for are:

- group term life insurance up to $50,000;
- employer provided accident and health insurance (provided there is no deferral of compensation and the policies meet certain other requirements);
- COBRA premiums;
- premiums for individual health insurance premiums that are excludable for gross income;
- dependent care FSAs;
- short- and long-term disability benefits;
- paid time off (provided there is no compensation deferred to a later taxable year);
- contributions to a health savings account ("HSA"); and
- contributions to a 401(k) plan

Among the specified nonqualified benefits are:

- scholarships;
- employer provided meals and lodging;
- educational assistance programs;
- fringe benefits;
- long-term care insurance;
- long-term care services (though HSA funds may be used to pay for long-term care insurance premiums or for long-term care services, and contributions to an HSA would be a qualified benefit);
- group term life insurance for a spouse or dependent;
- contributions to health reimbursement arrangements;
- contributions to Archer medical savings accounts; and
- elective deferrals under a Section 403(b) plan.

Written Document Required

The new rules, like the old, require that there be a written plan document, but the new rules also require that a wider, and more specific range of information, be included in the plan document. The written plan document must:

- specifically describe all benefits;
- set forth rules for eligibility and participation, including expressly allowing only employees to participate;
- state that all provisions of the plan apply uniformly to all participants;
- describe procedures for making elections, including that only employees (not spouses or dependents) may make or revoke elections;
- provide that all elections are irrevocable for the period of coverage, except for changes allowed under the change in status rules;
- state how employer contributions may be made;
- state the maximum amount of elective contributions;
- describe the plan year; and
- if the plan includes FSAs, include provisions complying with the uniform coverage and the use it or lose it rules.

Cafeteria Plan Elections

A cafeteria plan must require that employees make annual elections between taxable and qualified benefits, though midyear changes bases on specified status changes may be permitted. An exception to the one-time annual election requirement is made, however, for HSA contributions which can be modified as needed during the plan year.

Mid-year status change elections, and the reasons for them, are not mandatory, and are included at the employer's discretion. The election rules for salary reductions to an HSA, however, are mandatory (if the employer has a high-deductible health plan benefit option that would make an employee eligible to establish an HSA). If an HSA contribution is available: (i) it must be described in the plan document; (ii) the participant must be allowed to change his election on a monthly or more frequent schedule; and (iii) the plan must allow a participant who has become ineligible to contribute to an HSA to prospectively revoke his or her salary reduction election.

The regulations expressly allow for plans to: (i) permit elections for new employees within 30 days from their date of hire; (ii) allow for default elections should an employee fail to make an election during an open enrollment period; and (iii) have elections be made electronically.

Flexible Spending Accounts

The new rules retain many of the old rules applicable to FSAs, such as the uniform coverage rule, the use-it-or-lose-it rule, the 12-month period of coverage rule, and the rule that expenses incurred before or after the coverage period are not reimbursable. The new rules clarify that the period of coverage need not be the plan year and need not be the same for different FSAs. They also allow the plan to specify any interval for salary reduction so long as it applies uniformly to all participants.

Health FSAs may only reimburse health care expenses, but need not reimburse participants for all types of health care expenses. Any exceptions must be noted in the plan document. Participation in a health FSA may be limited to those who are enrolled in the employer's health and accident plan. There is also guidance on the use of limited purpose, post-deductible, and combination FSAs in conjunction with HSAs.

The new rules incorporate prior guidance about qualified transfers from FSAs to HSAs between December 20, 2006, and December 31, 2011. The plan, however, must be amended to take advantage of this guidance.

Dependent care expenses may be reimbursed if incurred after termination of employment, but the plan document must include this option.

The new rules clarify that an expense must be substantiated before it can be paid for or reimbursed, and substantiation must be by an independent third party. Self-substantiation and self-certification of an expense is not permitted.

The new regulations contain a host of requirements for substantiation of expenses using debit cards, many of which were included in prior guidance. The new rules also allow for the use of debit cards for dependent care FSAs. The final regulations, however, retain the rule that expenses may not be reimbursed before the services are provided, even if advance payment is required by a day care provider.

NonDiscrimination Rules

This has been perhaps the most confusing area of cafeteria plan administration and the area where additional guidance has been most needed. The new rules bring the cafeteria plan discrimination rules closer to those for retirement plans, and provide objective tests for determining if the plan is discriminatory.

FOR FURTHER INFORMATION

Please call one of the employee benefits attorneys listed on this page if you have any questions about these rules and whether your current cafeteria plan meets these new requirements, or if you have any other concerns about your employee benefit programs.

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