



## American Compliance Employer Guide The New IRS Section 125 Cafeteria Plan Regulations

August 2007

### **Introduction**

On August 3, 2007 the IRS released a comprehensive set of proposed regulations that apply to Section 125 Cafeteria Plans (referred in this guide as the “new regulations”). Published in the Federal Register on August 6, these new regulations replace and consolidate prior guidance released since the 1980’s.

The effective date of the new regulations is generally plan years beginning 1/1/2009 or later; however, new rules related to taxable income calculations for excess group term life insurance are effective immediately. Employers also have the option to rely on these new regulations prior to the effective date.

The IRS is accepting comments on the new regulations until Nov. 5, 2007 and a hearing has also been scheduled for Nov. 15, 2007. It is expected that the IRS will release final regulations in 2008 which incorporate information received from the comments and meetings. Hopefully additional guidance is issued in time for employers and administrators to make any cafeteria plan document and administrative changes necessary prior to plan dates beginning January 1, 2009.

### **Contents of New Proposed Regulations**

The new regulations are made up of five sections:

- 1.125-1: Qualified and nonqualified benefits in a cafeteria plan
- 1.125-2: Elections in cafeteria plans
- 1.125-5: Flexible spending arrangements
- 1.125-6: Substantiation of expenses
- 1.125-7: Nondiscrimination rules

The new regulations do not deal with issues covered in sections 1.125-3 and 1.125-4. Final regulations have already been released by the IRS that address the interaction of the Family and Medical Leave Act (FMLA) and Section 125 Cafeteria Plans (1.125-3), and rules defining permissible election changes (1.125-4).

Much of what is contained in the new regulations is a consolidation of previous guidance. In fact, many issues that some commenters have anticipated would be included are conspicuously absent. For example, it has been widely speculated that the IRS may make changes to, or even eliminate, the use-it or lose-it rule, but the rule remains intact in the new regulations.

This employer guide is structured in the order of the new regulation's sections, and is principally focused on changes, clarifications and outstanding issues related to the proposed rules. Content in *italics* indicates a direct quote from the new regulations.

### **1.125-1: Qualified and nonqualified benefits in a cafeteria plan**

Section 1.125-1 contains guidance on a number of important general administration rules for cafeteria plans including what benefits can be included in a plan, and expanded written cafeteria plan document requirements.

#### **The Exclusive Rule**

The new regulations clearly state that the “*exclusive*” way for an employee to avoid taxation when they are given the choice between taxable and non-taxable benefits is through a Section 125 Cafeteria Plan that meets all the requirements defined in the new regulations. Even though the new regulations use the word “exclusive”, it should be noted there are other rules that allow similar tax treatment for non-Section 125 benefits such as Section 132 of the Internal Revenue Code which allows pre-tax deductions for qualified transportation expenses.

#### **Written Plan Requirements**

The new regulations expand and clarify existing cafeteria plan document requirements, and specify certain elements that must be included in the cafeteria plan document. All provisions of the plan must apply uniformly to all participants. The cafeteria plan document must:

- Set forth the rules for eligibility to participate and the procedure for making elections
- Provide that all elections are irrevocable (except to the extent that the plan includes the optional change in status rules in §1.125-4)
- State how employer contributions may be made under the plan (for example, salary reduction or nonelective employer contributions)
- Identify the maximum amount of elective contributions
- Define the plan year
- Specify that only employees may participate in the cafeteria plan

- Include provisions complying with the uniform coverage rule, and the use-or-lose rule if the plan includes a flexible spending arrangement (FSA)
- Describe HSA salary reduction rules if an HSA is offered through the cafeteria plan

### **Qualified Benefits**

The new regulations define the benefits qualified to be offered through a cafeteria plan.

Consistent with prior rules the following benefits are considered qualified benefits:

- Employer provided accident and health
- Group term life insurance
- Short and long term disability
- Dependent care FSA
- 401(k) contributions

Additional benefits have been added, clarified or expressly defined in the new regulations as a qualified benefit:

- Health FSAs
- AD&D policies
- Contributions to HSAs
- COBRA premiums
- Adoption assistance programs
- Individual accident and health policies

### **Non-Qualified Benefits**

Legal Service Plans, a benefit that had sometimes been included in cafeteria plans in the past, are no longer a qualified benefit. The new regulations restate the prohibition of including a number of non-qualified benefits in a cafeteria plan:

- *(i) Scholarships described in section 117;*
- *(ii) Employer-provided meals and lodging described in section 119;*
- *(iii) Educational assistance described in section 127;*
- *(iv) Fringe benefits described in section 132;*
- *(v) Long-term care insurance, or any product which is advertised, marketed or offered as long-term care insurance;*
- *(vi) Long-term care services (but see paragraph (q)(3) of this section);*
- *(vii) Group-term life insurance on the life of any individual other than an employee (whether includible or excludible from the employee's gross income);*
- *(viii) Health reimbursement arrangements (HRAs) that provide reimbursements up to a maximum dollar amount for a coverage period and that all or any unused amount at*

*the end of a coverage period is carried forward to increase the maximum reimbursement amount in subsequent coverage periods;*

- *(ix) Contributions to Archer MSAs (section 220); and*
- *(x) Elective deferrals to a section 403(b) plan.*

Other than benefits expressly allowed in the new regulations, non-qualified benefits may not be offered through a cafeteria plan, even if paid after tax.

## **Other Benefit Issues**

### COBRA premiums

As under prior rules, employees are allowed to make pre-tax election to pay for COBRA premiums due to the same plan sponsor as the sponsor of the cafeteria plan. This provision has often been used to pay COBRA premiums pre-tax when a dependent loses eligibility.

The new regulations, however, now allow an employee to pay COBRA premiums due to a different plan sponsor than the sponsor of the cafeteria plan. This would allow the employee to make a pre-tax election at a new employer to pay for COBRA premiums due to his previous employer.

The new regulations seem to suggest that COBRA premiums due for spouse only and/or dependent only coverage may not be paid using pre-tax dollars. This may be a mistake and it is possible that this will be changed in the final regulations.

### Group Life Insurance

Employer provided group term life insurance under \$50,000 is excluded from the employee's income under IRS code section 79. The new regulations change how to calculate what to include as taxable income for amounts exceeding \$50,000. Previously the value of the excess life insurance based on the IRS Table 1 rates or the actual pre-tax deduction amount, whichever was greater, was used to determine taxable income. Under the new regulations only Table 1 rates are used to determine the amount to be added to the employee's taxable income. This change is effective immediately so it will affect calculations for 2007 W-2s.

### Individual Health Insurance Policies

The new regulations attempt to clarify the conditions when an employee can have pre-tax deductions made to pay for individually purchased health insurance. The reimbursements can be in the form of a check made out directly to the insurance carrier or in the name of

both the employee and the insurance carrier. Alternatively, the reimbursement can be made directly to the employee if they substantiate their payment to the insurance company.

#### Domestic Partner Coverage

The new regulations formalize guidance from prior Private Letter Rulings (PLRs) allowing the purchase of domestic partner coverage through the cafeteria plan using after tax dollars.

#### Grace Period

Plans may continue to offer the optional 2½-month grace period described in previous guidance. The new regulations contain a new cafeteria plan document requirement related to the grace periods. The plan must specifically state “...*unused benefits or contributions relating to a particular qualified benefit may only be used to pay or reimburse expenses incurred with respect to the same qualified benefit.*”

#### No Deferral of Compensation

As has always been the case, cafeteria plans may not allow deferral of compensation from one plan year to another so benefits such as cash value life insurance may not be offered. The new regulations provide for a number of provisions found in some benefit plans that apply to more than one year, yet are not considered deferral of compensation, thus are allowed in cafeteria plan (e.g. reasonable lifetime benefits on health plans, premium waiver during disability, coverage for a specific accident or disease and long-term disability coverage that pays benefits for more than one year).

The new regulations also finally clarified that salary reductions taken out of an individual's pay during the last month of a plan year that are used to pay premiums for the first month of the following plan year do not constitute deferred compensation.

Mandatory two-year vision and dental elections are also allowed as long as salary reductions from one year are not used to pay for benefits in the following year.

#### Definition of Dependent

In 2004, the definition of dependent changed in the Tax Code, altering the status of some individuals previously defined as a dependent. The IRS then issued guidance clarifying when an individual's dependent status for health insurance could be different from the tax related definition. The new regulations make the definition of a dependent in a cafeteria plan dependent on any Code definition for the underlying benefit. In other words, the definition of dependent in a cafeteria plan will be consistent with the Section 152 tax related definition,

unless there are different rules that apply to a benefit within the cafeteria plan such as the health care dependent definition in Section 105.

## **1.125-2: Elections in Cafeteria Plans**

Other than a new rule related to elections by new employees (described below) and more information on electronic elections, the new regulations do not significantly change procedures for employee elections to a cafeteria plan.

### **HSA Elections in a Cafeteria Plan**

The new regulations incorporate previous guidance from the IRS regarding running HSA contributions through the cafeteria plan, including the requirement that the plan allow prospective changes to HSA salary reduction amount for any reason and that changes must be allowed on at least a monthly basis

If HSA contributions are allowed, they must be described in the cafeteria plan document, and the plan must allow individuals to revoke election if they become ineligible to contribute to the HSA.

### **New Employee Elections**

A significant election rule contained in the new regulations makes clear that it is permissible to make a new employee's cafeteria plan election retroactive up to 30 days. This must be incorporated into the eligibility rules in the cafeteria plan document.

- Payroll deductions must be made from income available after the election.
- Retroactive coverage is not allowed for an employee who returns to work after a termination or unpaid leave of less than 30 days.

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

The section of the new regulations that deals with Flexible Spending Arrangements (FSAs) continues most of the practices and previous guidance. The use-it or lose-it rule (now called the "use or lose" rule in the new regulation) continues to apply to health and dependent care FSAs. Health FSAs are also still subject to the uniform coverage rule. In fact the IRS includes a warning in the new regulations that "outside deals" between the employer and employee that have the effect of circumventing the uniform coverage rule will be considered in determining if a cafeteria plan is in compliance.

### Advanced Orthodontia Payments

Normally medical costs may not be reimbursed until the service is actually rendered. Consistent with previous IRS comments the new regulations allow advance orthodontia

payments that are “required” to be reimbursed even though services have not yet been provided.

#### Dependent Care Expenses Reimbursement Spend Down

The new regulations incorporate an optional provision that allows a terminated employee to be reimbursed for dependent care expenses that are incurred after their termination date. Reimbursements can only be made up to the amount that had been deducted from their pay at the time of the termination. If an employer chooses to offer this optional benefit, it must be included in the cafeteria plan document.

### **1.125-6: Substantiation of expenses**

The new regulations confirm previous IRS guidance that advance reimbursements are not allowed. All claims must be substantiated prior to reimbursement.

#### General Substantiation Rules

As in previous rules, cafeteria plans may only reimburse benefits incurred during period of coverage with the exception of the optional dependent care spend down provision described above. “Sampling” substantiation methods or the practice of not substantiating claims below a certain level are also not permitted.

Some employers and administrators have adopted “creative” substantiation methods over the years. Even though the substantiation rules are not new, enough has been clarified that employers should carefully review their current substantiation procedures to assure they are consistent with the new regulations.

#### Debit Cards

The IRS has issued a number of notices and revenue rulings over the last few years regarding the use of debit cards for reimbursements. The only apparent change from this previous guidance is that the new regulations would allow the use of a debit card for reimbursements to former employees such as a COBRA continuee. Prior rules required termination of the card when an employee is terminated; the new regulations require the card to be terminated when the individual is no longer a participant.

A transition period has been extended to plan years beginning 1/1/09 or later to adopt the new merchant rules articulated in prior guidance.

#### Debit cards for Dependent Care expenses

A provision allowing the use of debit cards for the reimbursements of dependent care expenses is included in the new regulations. Dependent care expenses reimbursed using a debit card may not be reimbursed before services are provided. An administrator is allowed to make funds available on a regular schedule based on a documented provider payment schedule.

### **1.125-7: Nondiscrimination rules**

Some of the more significant changes in the new regulations address nondiscrimination testing. Notably the new regulations include:

- New definitions
- A new key employee contribution test
- A safe harbor for Premium Only Plans

Some confusion has been created by the examples provided in the new regulations. Most analysts expect additional clarification from the IRS regarding nondiscrimination testing. At this point it is recommended that employers wait for additional guidance and/or the final regulations before considering changes to procedures based on new testing rules.

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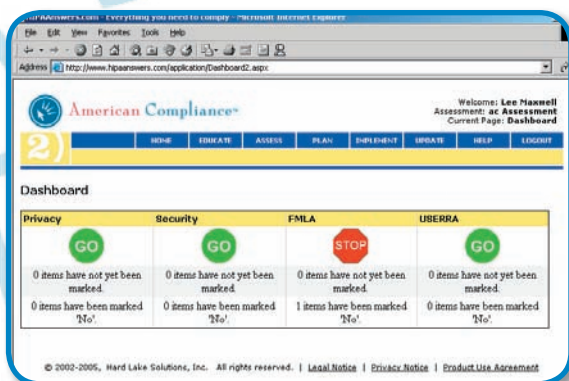
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