IRS Issues New Proposed Section 125 Cafeteria Plan Regulations

The Internal Revenue Service has issued new Proposed Regulations that would govern the design and operation of cafeteria plans established under Internal Revenue Code Section 125. The Proposed Regulations, which were published in the Federal Register on August 6, 2007, replace a series of proposed and temporary Section 125 regulations dating as far back as 1984, and incorporate numerous other IRS notices and rulings. The Proposed Regulations do not, however, alter the existing final cafeteria plan regulations on permissible mid-year election changes.

With limited exceptions, the Proposed Regulations, when finalized, would be effective for plan years beginning on or after January 1, 2009. Plan sponsors may rely on the Proposed Regulations until the rules are finalized.

The Proposed Regulations not only include guidance on recent legislation that affects cafeteria plans and consolidate existing guidance, but also make several significant changes that may impact a plan sponsor’s current benefit program. Those changes warrant thoughtful evaluation by plan sponsors. Some of the more significant changes and clarifications made by the Proposed Regulations are summarized below.

Significant Section 125 Cafeteria Plan Rule Changes

Plan Documentation. The Proposed Regulations confirm that the only way a plan sponsor may offer employees a choice between taxable and non-taxable benefits is through a separate written cafeteria plan (consisting of one or more documents) that complies with the requirements of Code Section 125. The cafeteria plan (or amendments to an existing cafeteria plan) must be adopted and effective on or before the first day of the plan year choices are permitted (or before the first day an amendment takes effect). The Proposed Regulations clarify that the plan must contain certain required elements, including:

- a description of the benefits offered through the plan;
- rules governing participation, employee elections, and contributions;
- special requirements applicable to any health care, dependent care, or adoption assistance flexible spending account (FSA); and
- provisions for contributions and distributions to a health savings account (HSA) (if offered).

Plans that include health care or dependent care FSAs must also describe any grace period rules that have been adopted.

Failure to meet the written plan rules—or failure to operate according to the terms of the written plan—would mean the plan is not a Section 125 cafeteria plan. As a result, employees would be subject to taxation on the value of the taxable benefit with the greatest value that they could have elected to receive. For example, if written documents that address all the specific items required by the Proposed Regulations are not in place by January 1, 2009, the premiums paid under a premium conversion plan would be taxable income to covered employees for 2009.
**Nondiscrimination Tests.** The Proposed Regulations provide significant new guidance that should alleviate some of the past uncertainty about applying the three basic nondiscrimination tests that apply to cafeteria plans: (i) the eligibility test; (ii) the contributions and benefits test; and (iii) the key employee test. For purposes of the nondiscrimination tests, the Proposed Regulations offer new definitions of several important terms, including *highly compensated individual, five percent shareholder, officer, key employee, highly compensated participant*, and *compensation*. The Proposed Regulations use a modification of the nondiscriminatory classification rule from the Code Section 410(b) qualified retirement plans rules to fashion a proposal for the eligibility test. The new guidance on the contributions and benefits test proposes an objective test, reminiscent of the ADP and ACP tests used for 401(k) plans, to determine when the actual election of benefits is discriminatory. Finally, the Proposed Regulations explain the safe harbor for cafeteria plans providing health benefits and create a safe harbor for premium-only plans that satisfy certain requirements.

The Proposed Regulations contemplate nondiscrimination tests on the last day of the plan year, taking into account all non-excludable employees and former employees who were employed on any day during the plan year. It is noteworthy that the new cafeteria plan nondiscrimination rules do not replace the nondiscrimination testing requirements that may apply to a component benefit plan under the cafeteria plan (such as a group-term life insurance plan, self-insured medical plan, or a dependent care assistance program).

**Group-Term Life Insurance.** The general rule under Code Section 79 is that the cost of group-term life insurance coverage in excess of $50,000 (less total employee after-tax contributions toward the cost of the coverage) under policies carried directly or indirectly by the employer is includible in the employee’s gross income. Guidance previously issued by the IRS (i.e., IRS Notice 89-110) indicated that the cost of this excess group-term life insurance coverage, when provided through a cafeteria plan, should be determined using the greater of (i) the actual cost of the coverage paid through salary reductions or flex credits, or (ii) the cost determined using the applicable rate in Table I of Treasury Regulation § 1.79–3(d)(2). Effective as of the August 6, 2007 date of publication in the Federal Register, the Proposed Regulations provide that the amount includible in the employee’s gross income on this excess group-term life insurance coverage is to be determined solely on the basis of the Table I rates. Under this new approach, the actual cost of the coverage paid through salary reductions or flex credits is excludable from the employee’s gross income. Although in most cases the tax impact on employees will be relatively minor, this change will require an adjustment in the way employers calculate the additional income to be imputed and reported on Form W-2 for employees who receive group-term life insurance coverage through a cafeteria plan, beginning with the 2007 tax year.

**Retroactive Enrollment for New Employees.** The Proposed Regulations permit a cafeteria plan to provide that employee coverage elections made within the first 30 days of employment can be retroactively effective as of the date of hire. Any pre-tax contributions used to pay for coverage during the retroactive period must be made from compensation that is not yet currently available when the coverage election is made. This special rule eliminates the need to require a new employee to pay for retroactive coverage through after-tax contributions. It should be noted that this rule does not apply to any employee who terminates employment and is rehired within 30 days after termination or who returns to employment following an unpaid leave of absence of less than 30 days.

**Permissible Benefits.** The Proposed Regulations confirm that the qualified benefits that may be provided through a cafeteria plan include accident and health benefits, health care FSAs, contributions to HSAs, dependent care assistance, adoption assistance, COBRA premiums, long-term and short-term disability coverages, accidental death and dismemberment insurance, group-term life insurance, 401(k) deferrals, and contributions for post-retirement life insurance under certain educational organization plans. The regulations confirm that funds from an HSA may be used to pay for eligible long-term care premiums on a qualified long-term care insurance contract or for long-term care services, even though these benefits may not be provided directly by the cafeteria plan.

**Deferral of Compensation.** The Proposed Regulations reiterate that a cafeteria plan generally may not offer benefits that defer compensation, and benefits generally may not be carried over or applied to a later plan year. The Proposed Regulations state, however, that certain features of an accident and health insurance policy that apply for more than one plan year do not violate the prohibition on deferral of compensation. These include reasonable lifetime limits on benefits, level premiums, premium waiver during disability, and guaranteed renewability of coverage. Other
noteworthy benefits and practices that are expressly identified as not providing for the deferral of compensation include a long-term disability policy paying benefits over more than one plan year, reasonable premium rebates or policy dividends, “two-year lock-in” vision and dental insurance arrangements, certain advance payments for orthodontia, salary reduction contributions in the last month of a plan year used to pay accident and health insurance premiums for the first month of the following plan year, and reimbursement of medical expenses for durable medical equipment.

**Dependent Care Expenses.** The Proposed Regulations confirm that a dependent care FSA may reimburse an employee for dependent care expenses incurred after participation in the cafeteria plan ends (for example, after termination of employment) and through the last day of that plan year. For plans that have adopted a 2½-month grace period rule, these participants can be permitted to use up remaining account balances until the end of that grace period.

**Debit Cards.** The Proposed Regulations consolidate previous guidance on how debit cards may be used by health care FSAs. The consolidated rules include special transitional rules for substantiation of medical expenses for health care FSA debit cards used for purchases at supermarkets, grocery stores, discount stores, and wholesale clubs that do not have a medical care merchant category code, and purchases through mail-order and web-based vendors that sell prescription drugs. The Proposed Regulations would also establish new rules that permit dependent care FSAs to pay or reimburse dependent care expenses through the use of debit cards.

**Plan Years.** The Proposed Regulations clarify that employers may change plan years for valid business reasons (for example, to conform to a change in an underlying benefit plan’s insurance policy renewal period). Short plan years of less than twelve consecutive months are also permissible for valid business purposes.

**Forfeitures.** The Proposed Regulations clarify that unused amounts forfeited by FSA participants (also referred to as “experience gains”) may be retained by the employer that sponsors the plan or used to pay administrative expenses. These forfeiture amounts may also be used to reduce employee contributions for the next plan year or returned to employees on a reasonable and uniform basis.

**Action Steps for Plan Sponsors**

As a result of the Proposed Regulations, plan sponsors should review their cafeteria plan design and operations to identify compliance gaps that will require attention if the Proposed Regulations are finalized in their current form. In particular, consideration should be given to program changes that may be needed to assure satisfactory nondiscrimination test results. Plan sponsors that wish to rely on the Proposed Regulations also may need to revise their cafeteria plan and underlying component benefit plan documentation in a timely manner to be consistent with the new requirements, and communicate any changes to covered employees.

Aon Consulting can assist plan sponsors in evaluating and revising their current cafeteria plans in light of the Proposed Regulations. If you have any questions, please contact your local Aon Consulting representative.

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