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EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION
ADVISORY

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Boston

Washington

New York

Stamford

Los Angeles

Palo Alto

San Diego

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www.mintz.com

One Financial Center
Boston, Massachusetts 02111
617 542 6000
617 542 2241 fax

701 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
202 434 7300
202 434 7400 fax

666 Third Avenue
New York, New York 10017
212 935 3000
212 983 3115 fax

707 Summer Street
Stamford, Connecticut 06901
203 658 1700

IRS Issues (Comprehensive) Proposed Cafeteria Plan Regulations

On August 6, 2007, the Internal Revenue Service issued newly proposed cafeteria plan regulations under Internal Revenue Code § 125. According to a news release issued by IRS and the Treasury Department, the new rules "generally preserve the rules of the existing proposed regulations, while adding clarifications [to previously issued guidance going back some 23 years]." While this may be the case, the new proposal includes a handful of important changes that will materially impact cafeteria plan operation and maintenance. This client advisory explains the key features of the new proposed regulations.

Background

Congress adopted Code § 125 in 1978 as part of the Revenue Act of 1978[1] for the purpose of permitting employees to choose among taxable and nontaxable benefits without being deemed to be in constructive receipt of income. A cafeteria plan is defined to mean a written plan under which:

- all participants are employees, and
- participants may choose among two or more benefits consisting of cash and certain nontaxable or "qualified" benefits.

Absent § 125 (at least as interpreted by the IRS), the choice between a taxable and nontaxable benefit results in current tax irrespective of the option selected, but, pursuant to a valid cafeteria plan election, employees who choose a nontaxable benefit do not incur tax.

Cafeteria plans generally follow one of three basic designs:

- *Premium-only plan*. Under a premium-only arrangement, employees are allowed to choose between salary and payment of the employee's premium contribution under the employer's group health plan and, in some instances, under other non-group

203 658 1701 fax

1620 26th Street
Santa Monica, California 90404
310 586 3200
310 586 3202 fax

1400 Page Mill Road
Palo Alto, California 94304
650 251 7700
650 251 7739 fax

9255 Towne Centre Drive
San Diego, California 92121
858 320 3000
858 320 3001 fax

The Rectory
9 Ironmonger Lane
London EC2V 8EY England
+44 (0) 20 7726 4000
+44 (0) 20 7726 0055 fax

health plans;

- *Flexible Spending Arrangements (FSAs)*. Under an FSA, an employee is permitted to elect to have a portion of his or her salary withheld on a pre-tax basis for the purpose of paying for uninsured health care expenses, dependent care expenses or adoption-assistance expenses.

- *Flexible Benefits/Full-Flex/Flex-Credit Plans*. Under a flexible benefits plan (alternately referred to as a "full-flex" or "flex-credit" plan), an employer makes available a menu of tax-free and taxable benefits, which the employee may elect to purchase with a combination of employer and employee contributions.

Proposed Reg. § 1.125-1: General Requirements

Cafeteria Plan Definition

Consistent with prior law and guidance, the new proposed regulations require that a cafeteria plan offer a choice between at least one "permitted taxable benefit" (such as cash or property) and at least one qualified or nontaxable benefit. Thus, a plan that offers a choice only among taxable benefits, or only among qualified benefits, is not a cafeteria plan. The regulations also make clear that the cafeteria plan rules are the exclusive means by which the choice between taxable and nontaxable benefits may be offered without triggering constructive receipt of income.

Written Plan

A cafeteria plan must be in writing, and it must be operated in accordance with the written plan terms. The written plan must:

- describe all benefits;
- specify the plan year;
- set forth the rules for eligibility to participate and the procedure for making elections;
- provide that all elections are irrevocable (other than in the case of mid-year election changes expressly permitted under Treas. Reg. § 1.125-4);
- state how employer contributions may be made under the plan (for example, salary reduction or non-elective employer contributions);
- establish the maximum amount of elective contributions; and
- specify that only employees may participate in the cafeteria plan.

Written FSA plan documents must include provisions complying with the uniform coverage rule and the use-or-lose rule (described below).

Individuals Who May Participate in a Cafeteria Plan

All participants in a cafeteria plan must be employees, which include:

- common law employees,
- leased employees, and
- certain "full-time life insurance salesmen."

A cafeteria plan may cover former employees, but a plan may not be maintained predominantly for former employees. And while a participant's spouse or dependents may receive benefits through a cafeteria plan, they cannot participate in the cafeteria plan. Self-employed individuals are not treated as employees. Thus, sole proprietors, partners, 2% shareholders of S corporations and directors of corporations are not employees and they may not participate in a cafeteria plan (but a sole proprietor or partnership can maintain a cafeteria plan for common law employees).

Election between Taxable and Nontaxable Benefits

A cafeteria plan must offer employees an election among only permitted taxable benefits (including cash) and qualified/nontaxable benefits. For this purpose, "cash" means cash from current compensation (including salary reduction), payment for annual leave, sick leave or other paid time off, severance pay, property, and certain after-tax employee contributions. Distributions from qualified retirement plans are not cash or taxable benefits. Qualified benefits include:

- group-term life insurance on the life of an employee;
- employer-provided accident and health plans (including health flexible spending arrangements and accidental death and dismemberment policies);
- dependent care assistance;
- adoption assistance;
- 401(k) plan contributions;
- contributions to certain plans maintained by educational organizations; and
- contributions to Health Savings Accounts (HSAs).

Group-Term Life Insurance

Under Code § 79, the premium cost of employer-sponsored group life insurance in excess of $50,000 is generally taxable to employees. Under prior guidance, (*i.e.*, IRS Notice 89-110), the cost of excess coverage was the greater of either the actual cost of coverage paid through salary reduction or flex credits, or the cost determined under the applicable Table I of Treas. Reg. § 1.79-3(d)(2). The new proposed regulations require employees to include in gross income the Table I cost of excess coverage.

Employer-Provided Accident and Health Plans

Coverage under an employer-provided accident and health plan may be provided as a qualified benefit through a cafeteria plan. But in the case of self-funded plans and medical FSAs, the Code § 105(h) nondiscrimination apply. While a cafeteria plan may pay or reimburse substantiated individual accident and health insurance premiums, a medical FSA may not. A cafeteria plan may also provide for the payment of COBRA premiums for an employee.

The proposed regulations make clear that only dependents who satisfy the Code's definition of "dependent" are eligible for the exclusion from employees' gross income for accident and health plans and medical FSAs.

Dependent Care Assistance Programs and Adoption Assistance Programs

If the requirements of Code § 129 are satisfied, up to $5,000 of employer-provided assistance for amounts paid or incurred by employees for dependent care is excludible from employees' gross income. The new proposed regulations outline the general requirements for providing dependent care assistance programs and adoption assistance.

No Deferral of Compensation

A cafeteria plan may not generally offer benefits that defer compensation or operate to defer compensation—*i.e.*, benefits may not be carried over to a later plan year or used in one plan year to purchase benefits to be provided in a later plan year. Despite this bar, certain practices are permitted. An accident and health insurance policy, for example, may impose reasonable lifetime limits on benefits, level premiums, premium waiver during disability, guaranteed renewability of coverage, coverage for specified accidental injury or specific diseases, and the payment of a fixed amount per day for hospitalization. Also, the following benefits and practices are deemed to not impermissibly defer compensation for cafeteria plan purposes:

- long-term disability benefits paid over more than one plan year;

- reasonable premium rebates or policy dividends;
- certain two-year lock-in vision and dental policies;
- 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;
- reimbursement for certain durable medical equipment; and
- allocation of experience gains (*i.e.*, forfeitures) among participants.

Paid Time Off

Permitted taxable benefits include various forms of paid leave and vacation days, which the new proposed regulations refer to as "paid time off." But a plan offering an election solely between paid time off and taxable benefits is not a cafeteria plan.

Grace Period

The new proposed regulations carry over prior law rules allowing FSAs to provide an optional grace period of up to 2½ months immediately following the end of each plan year, thereby extending the period for incurring expenses for qualified benefits. A grace period may apply to one or more qualified benefits (for example, health FSA or dependent care assistance program) but it may not apply to paid time off or 401(k) plan contributions. Unused benefits or contributions for one qualified benefit may only be used to reimburse expenses incurred during the grace period for that same qualified benefit. The employer may limit the amount of unused benefits and contributions available during the grace period, and benefits not used as of the end of the grace period must be forfeited under the use-or-lose rule.

Nonqualified Benefits

A cafeteria plan cannot offer any of the following benefits:

- scholarships;
- employer-provided meals and lodging;
- educational assistance;
- fringe benefits;
- contributions to Archer Medical Savings Accounts;

- group-term life insurance for an employee's spouse, child or dependent;
- elective deferrals to tax-sheltered annuity plans; or
- long-term care insurance.

> **NOTE:** Despite the bar on long-term care insurance, an HSA funded through a cafeteria plan may be used to pay premiums for long-term care insurance or for long-term care services.

A plan offering any nonqualified benefit is not a cafeteria plan.

After-Tax Employee Contributions

In a significant clarification of prior law, the new proposed regulations allow a cafeteria plan to offer *after-tax* employee contributions for qualified benefits or paid time off.

> **NOTE:** This provision is useful, for example, in the case of employers in Massachusetts that offer cafeteria plan access to employees who are ineligible for employer-sponsored group health plans and who are provided access to insurance products offered through the Connector in compliance with the "section 125 cafeteria plan" requirement.

Proposed Reg. § 1.125-2: Elections in Cafeteria Plans

Generally, a cafeteria plan must require annual elections, which must be made before the earlier of either the first day of the period of coverage, or when benefits are first currently available. Certain mid-year elections are permitted under existing rules (*see* Treas. Reg. § 1.125-4) only if the mid-year election change rules are included in the written cafeteria plan document. There is also a special rule that applies to salary-reduction HSAs, under which employees may prospectively elect, revoke or change salary reduction elections for HSA contributions at any time during the plan year with respect to salary that has not become currently available at the time of the election. Also, automatic elections are permitted, and elections and revocations or changes in elections can be made electronically.

Proposed Reg. § 1.125-5: Flexible Spending Arrangements

The newly proposed regulations recognize the three types of FSAs:

- dependent care assistance,
- adoption assistance, and
- medical care reimbursements.

FSAs are designed to reimburse employees for expenses incurred for certain qualified benefits up to a designated amount. The maximum amount of reimbursement reasonably available must be less than five times the value of the coverage. Non-elective employer contributions (or so-called "flex-credits") can be used at the employee's election for qualified benefits.

Uniform Coverage Rule

Under the "uniform coverage rule," the maximum amount of reimbursement from a health FSA must be available at all times during the period of coverage (reduced as of any particular time for prior reimbursements). The uniform coverage rule applies only to medical FSAs; it does not apply to FSAs for dependent care assistance or adoption assistance.

Use-or-Lose Rule

In order to satisfy the "no deferral of compensation" requirement, all benefits and contributions must be used by the end of the plan year (or grace period, if applicable) or they must be forfeited.

Period of Coverage

The required period of coverage for all FSAs is twelve months, with an exception for short plan years that satisfy the conditions in the new proposed regulations. The period of coverage and the plan year need not be the same.

> **NOTE:** The addition of rules relating to short plans years is particularly welcome. These rules were generally absent from prior guidance, leaving employers to guess at how to operate a short plan year where necessary.

Health FSAs

A health FSA may only reimburse certain substantiated medical care expenses incurred by the employee, or by the employee's spouse or dependents. A health FSA may be limited to a subset of permitted medical expenses (*e.g.*, a health FSA may be permitted to exclude reimbursement of over-the-counter drugs). Similarly, a health FSA may be a limited-purpose health FSA or post-deductible health FSA—*i.e.*, an FSA that is designed to be compatible with the HSA requirement that an employee must be covered under a high-deductible health plan and not be covered under any other plan (such as a traditional medical FSA) that is not a high-deductible health plan.

Dependent Care Assistance after Termination

Under an optional rule, a dependent care FSA may permit an employer to reimburse a terminated employee's qualified dependent care expenses incurred after termination through a dependent care FSA. This rule is referred to as the "optional spend-down provision."

Experience Gains

Unused amounts are referred to under the proposed regulations as "experience gains." The new rules retain the forfeiture allocation rules of prior guidance under which the employer sponsoring the cafeteria plan may:

- retain forfeitures;
- use forfeitures to defray expenses of administering the plan; or
- allocate forfeitures among employees contributing through salary reduction on a reasonable and uniform basis.

Proposed Reg. §1.125-6: Substantiation of Expenses for All Cafeteria Plans

Incurring and Reimbursing Expenses for Qualified Benefits

Only expenses for qualified benefits incurred after the later of the effective date or the adoption date of the cafeteria plan are permitted to be reimbursed under the cafeteria plan. Similarly, if a plan amendment adds a new qualified benefit, only expenses incurred after the later of the effective date or the adoption date are eligible for reimbursement. This rule applies to all qualified benefits. A cafeteria plan may pay or reimburse only expenses for qualified benefits incurred during a participant's period of coverage.

Substantiation and Reimbursement of Expenses for Qualified Benefits

A cafeteria plan may only pay or reimburse an expense that is:

- properly substantiated;
- incurred on or after the date the employee enrolls in a particular qualified benefit; and

- incurred at a time that the employee was covered under the particular benefit (except in the case of dependent care FSA under the optional spend-down provision).

NOTE: Under this requirement, all expenses must be substantiated, not just a statistical sample.

Debit Cards

The proposed regulation consolidates prior items of guidance relating to substantiating, paying and reimbursing medical care expenses with a debit card. Particularly useful are the rules relating to permissible methods of substantiation, which include co-payment matches, recurring expenses, and real-time substantiation. Also allowed is substantiation through matching inventory information.

The proposed regulation contains the following mandatory rules for all debit cards under medical FSAs:

(1) The employee must agree in advance, in writing that (i) he or she will only use the card to pay for medical expenses of the employee or his or her spouse or dependents, (ii) he or she will not use the debit card for any medical expense that has already been reimbursed, (iii) he or she will not seek reimbursement under any other health plan for any expense paid for with a debit card, and (iv) he or she will acquire and retain sufficient documentation (including invoices and receipts) for any expense paid with the debit card;

(2) The debit card must include a statement (presumably on the back of the card) providing that the agreements described above apply each time the employee uses the card;

(3) The amount available through the debit card must equal the amount elected by the employee for the health FSA for the cafeteria plan year (reduced by amounts paid or reimbursed during the plan year);

(4) The debit card must be automatically cancelled when the employee ceases to participate in the health FSA;

(5) The employer must limit use of the debit card to (i) physicians, dentists, vision care, hospitals,

other medical care providers (as identified by the merchant category code), (ii) stores with the appropriate merchant category codes, and (iii) stores that have implemented certain inventory information approval systems.

(6) The employer must substantiate claims in the manner specified by the proposed regulation; and

(7) The employer follows designated correction procedures for any improper payments.

> **NOTE:** Debit cards are gaining acceptance in the medical FSA marketplace, but the substantiation requirement stands as the single largest impediment to their wholesale adoption. The substantiation requirements of the proposed regulation will likely be viewed by employer groups, trade organizations and third-party vendors, among others, as too restrictive.

Proposed Reg. §1.125-7: Nondiscrimination

It is with respect to the cafeteria plan nondiscrimination rules that the proposed regulations will have their greatest impact. Prior guidance was vague, and employers often failed to focus on (and in some instances even bother with) the nondiscrimination rules. Drawing on the nondiscrimination rules that apply to tax-qualified retirement plans, the proposed regulations for the first time establish clear but potentially burdensome nondiscrimination standards.

Under Code § 125, a cafeteria plan may not discriminate in favor of highly compensated individuals with respect to eligibility or with respect to highly compensated participants as to contributions and benefits. In addition, nontaxable benefits provided to key employees cannot exceed 25% of nontaxable benefits provided to all employees under the plan. Discriminatory benefits provided to highly compensated individuals, highly compensated participants and key employees must be included in these employees' gross income.

The new proposed regulations define several key terms, including highly compensated individual or participant (consistent with the Code § 414(q) definition of highly compensated employee), officer, five percent shareholder, key employee and compensation, and they also provide guidance on the nondiscrimination as to eligibility requirement by incorporating certain rules under Code § 410(b) dealing with reasonable classification, the safe harbor percentage test and the unsafe harbor percentage component of the facts and circumstances test.

Testing under the new rules must be performed as of 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 year. Also, as was the case with prior guidance, the new nondiscrimination standards are in addition to, and do not displace, the nondiscrimination rules that are specific to the underlying benefit (*e.g.*, the nondiscrimination rules that apply separately to self-funded medical plans).

Eligibility

The eligibility test requires that the classification of eligible employees must be reasonable and that the eligible group must pass either the "safe harbor" or the "facts and circumstances test" of Code § 410(b) (these are some of the tests that apply to tax-qualified retirement plans). In applying these tests, a cafeteria plan may exclude employees (other than key employees) who are covered by a collectively bargained plan, nonresident aliens who receive no income from sources within the United States and employees on 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.

Contributions and Benefits

All similarly situated participants must have a uniform opportunity to elect qualified benefits, and highly compensated participants must not elect benefits at a disproportionate rate when compared to non-highly compensated participants. All similarly situated participants must also have a uniform opportunity to elect any employer contributions, and the actual election of employer contributions may not disproportionately favor highly compensated participants. Lastly, the aggregate employer contributions for highly compensated participants (measured as a percentage of aggregate compensation) may not exceed the aggregate contributions utilized by non-highly compensated participants (also measured as a percentage of aggregate compensation).

The proposed regulations establish two safe harbors, under which a plan is deemed to be nondiscriminatory:

- *Equal cost safe harbor*. A plan satisfies this safe harbor if contributions on behalf of each participant include an amount which either equals 100% of the cost of the health benefit coverage under the plan of the majority of similarly situated highly compensated participants, or equals or exceeds 75% of the cost of the health benefit coverage of the similarly situated participants having the highest cost health benefit coverage under the plan, and contributions or benefits in excess of these amounts bear a uniform relationship to compensation. In determining which participants are "similarly situated," reasonable differences in plan benefits may be taken into account (*e.g.*, variations in plan benefits offered to employees with family coverage versus employee-only coverage).

- *Premium-only safe harbor.* The second safe harbor applies only to premium-only arrangements (*i.e.*, plans that offer only elections between cash and pre-tax payment of the employee's share of the employer-provided accident and health insurance premium), and it is satisfied if:
  - the plan benefits a classification of employees that is found by the IRS not to discriminate in favor of highly compensated participants;
  - no employee is required to complete more than three years of service to participate; and
  - each employee can participate in the plan the first day of the plan year after meeting the service requirement.

Effective Date

The regulations generally apply to plan years beginning on or after January 1, 2009.

Conclusion

With the issuance of these proposed cafeteria plan regulations, the IRS and Treasury have ushered in a new era of cafeteria plan regulation. While the exact contours of this new era will not be known until the regulators react to public comments, most observers expect the basic framework of these newly proposed rules to survive pretty much in tact. This means that the adoption and operation of cafeteria plans will soon be more formal than under current law, particularly with respect to documentation, substantiation and nondiscrimination testing.

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[1] P.L. 95-600, § 134(a).

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If you have any questions concerning the information discussed in this advisory or any other employee benefits topic, please contact one of the attorneys listed below or your primary contact with the firm who can direct you to the right person. We would be delighted to work with you.

Alden Bianchi
617.348.3057 | AJBianchi@mintz.com

Tom Greene
617.348.1886 | TMGreene@mintz.com

Addy Press
617.348.1659 | ACPress@mintz.com

Pamela Fleming
617.348.1664 | PBFleming@mintz.com