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**BENE BULLETIN**

**IRS Consolidates and Updates  
Cafeteria Plan Regulations**

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On August 6, 2007 the IRS issued new proposed regulations that consolidate, update and replace existing proposed regulations and interim guidance for cafeteria plans. The new proposed regulations are expected to be effective January 1, 2009, although employers looking to take advantage of the proposed changes may rely upon the new rules immediately.

The IRS cafeteria plan guidance over the years has been abundant, but primarily in the form of piecemeal proposed and temporary regulations. The new proposed regulations consolidate the existing guidance and add much needed clarification in the areas of plan design, operation and nondiscrimination.

The proposed regulations are organized in a relatively intuitive user-friendly format. The sections are as follows:

General rules on qualified and nonqualified benefits in cafeteria plans	(§1.125-1)
General rules on elections	(§1.125-2)
Effect of the Family Medical Leave Act (FMLA) on cafeteria plans	(§1.125-3*)
Permitted election changes	(§1.125-4*)
General rules on flexible spending arrangements	(§1.125-5)
General rules on substantiation of expenses for qualified benefits	(§1.125-6)
Nondiscrimination rules	(§1.125-7)

\*The final regulations issued by the IRS in 2001 are unchanged by this release. We discuss the key provisions of the proposed regulations, by section, below.

**§ 1.125-1 – General rules on qualified and nonqualified benefits in cafeteria plans**

**The Basics.** The proposed regulations reinforce a fundamental rule that forms the foundation for the design and administration of cafeteria plans. In the proposed regulations, the IRS states unequivocally that a cafeteria plan is the sole mechanism by which an employer can offer

employees a choice between taxable and nontaxable benefits without the choice itself resulting in a taxable event to the employee. In other words, any pre-tax contributions made for qualified benefits must be made through a cafeteria plan that complies with IRS regulations. The IRS has long been skeptical about certain cash-for-benefit schemes that have been implemented outside of cafeteria plans. For example, some employers have offered their participants a choice between a cash-out of paid time off and a corresponding employer contribution to a health plan. The knowledgeable practitioners and the IRS have expressed a concern that this results in “constructive receipt” for the employee of the cash amount—resulting in taxable income. In the proposed regulations, the IRS states clearly and without qualification that these outside-the-box design strategies will not work. If these benefits are not offered through a section 125 plan, employers could be faced with having to correct W-2s, FICA and income tax, and employees will be taxed on the amounts that have been deducted from their pay on a pre-tax basis.

**Written Plan Requirement.** The proposed regulations re-emphasize that an arrangement will only qualify as a cafeteria plan if it is a written plan that permits participants to choose among at least one taxable benefit (such as cash or salary reduction) and at least one qualified benefit. The element of choice is important—if an employee is not permitted to opt-out, Code section 125 will not apply to the plan.

The written plan rules include the requirements that the written plan must be adopted and effective prior to the beginning of the plan year to which it applies; the terms of the plan must apply uniformly to all participants; and the plan may only benefit employees (not owners, such as partners paid according to a Form K-1, or 2% or greater shareholders of an S corporation). The proposed regulations provide important formal guidance by stating that former employees may participate in a cafeteria plan as long as the plan is not in existence predominantly for the benefit of former employees.

In addition, the proposed regulations provide guidance for certain dual-status individuals. An employee who is also a director, for example, may continue to participate in the cafeteria plan, but only with respect to amounts earned as an employee (not as a director).

**Cafeteria Plan Year.** Part of the written plan requirement is that a cafeteria plan year must be 12 consecutive months. A short year is permitted only for a valid business reason. Any change in plan year designed to circumvent cafeteria plan rules or for other than a valid business purpose will be disregarded, rendering the change in plan year ineffective.

**Individual Insurance and COBRA Premiums.** The new rules permit employers to use cafeteria plans to allow employees to pay for their own individual policies on a pre-tax basis. As long as the charges are substantiated, the plan may reimburse employees directly for the amount of the employee’s health insurance premium; issue the employee a check payable to the health insurance company for the amount of the employee’s health insurance premium, which the employee is obligated to tender to the insurance company; or issue a check payable jointly to the employee and the insurance company. A cafeteria plan may also allow an employee to pay COBRA premiums on a pre-tax basis. This can be useful when an employee wishes to pay COBRA premiums for a child that has reached the limiting age under the plan. This, of course, is not new. What is new, however, is that the proposed regulations permit an employee to pay

COBRA premiums on a pre-tax basis for a prior employer's coverage through the new employer's cafeteria plan. This is welcome relief for new employees, but should cause a bit of concern for employers, who may wonder if permitting their employees to pay premiums through their cafeteria plans to another employer's plan would make them co-plan sponsors of the other plan under general ERISA principles. Note that health FSAs may not reimburse individual or COBRA premiums.

**Group Term Life Insurance.** Another significant change in the proposed regulations relates to the taxation of group-term life insurance coverage (GTL) in excess of \$50,000. Employees are now taxed at the Table I rate for coverage in excess of \$50,000, regardless of whether the actual rate charged is higher or lower than the Table I rate (Table I is the rate table used by the IRS to calculate the value of employer-provided life insurance). In other words, the employee only includes in gross income the Table I cost of GTL in excess of \$50,000, minus all after-tax contributions made by the employee for GTL. The entire amount of salary reduction by the employee, as well as employer flex credits, is excludable from the employee's gross income. Unlike the effective date for other provisions, the rules regarding the cost of GTL being includable in income are effective immediately. GTL coverage that does not exceed \$50,000 remains excludable from the employee's gross income.

**No Deferral of Compensation.** Generally, cafeteria plans are prohibited from offering benefits that defer compensation from one plan year to the next. The new regulations clarify this rule and include several notable exceptions that permit certain two-year lock-in vision and dental policies; certain advance payment for orthodontia and durable medical equipment; and salary reductions made during the last month of a plan year to be used to pay for the next month, if done on a uniform and consistent basis for a group of participants.

**Grace Period.** The grace period rules adopted in 2005 are largely unchanged in the proposed rules. A cafeteria plan may include a grace period of up to two and one-half months after the end of the plan year, during which employees with unused contributions for a particular benefit (e.g., a health care FSA) may be reimbursed for expenses incurred during the grace period. Grace periods may apply to health care and dependent care FSAs and adoption assistance plans, but not elective paid time off, and funds from one account may not be used to reimburse expenses from another account. Employers may also limit the amount carried over during the grace period, as long as the limit is applied uniformly and is not based on a percentage of unused contributions remaining at the end of the plan year.

**Paid Time Off.** A cafeteria plan is permitted to include elective paid time off (PTO) (i.e., vacation days, sick days or personal days) as a permitted taxable benefit through the plan. This permits employees to receive more PTO than the employer normally provides, provided the plan does not operate to permit the deferral of compensation (e.g., a plan can permit employees to buy extra vacation days, as long as they are forfeited at the end of the plan year, and the plan deems nonelective PTO to be used before elective PTO). Additionally, a plan that only offers the choice of cash or paid time off is not a cafeteria plan and is not subject to the rules of Code section 125. Any grace period the employer has established does not apply to PTO.

**401(k) Contributions Through a Cafeteria Plan.** A cafeteria plan may include contributions to

a 401(k) plan expressed as a percentage of compensation. Automatic enrollment is also permitted (that is, when an employee does not affirmatively elect cash, his compensation is reduced by a fixed percentage, which is contributed to a Code section 401(k) plan).

**Certain Benefits Specifically Excluded.** A cafeteria plan must not offer any of the following benefits: scholarships; employer-provided meals and lodging; educational assistance; fringe benefits; or long-term care insurance. An HSA funded through a cafeteria plan may, however, be used to pay premiums for long-term care insurance or for long-term care services.

The new proposed regulations clarify that contributions to Archer Medical Savings Accounts, group term life insurance for an employee's spouse, child or dependent, and elective deferrals to Code section 403(b) plans are also not permitted. Any plan that offers impermissible nonqualified benefits, even if paid with after-tax employee contributions, is not a valid cafeteria plan. Among other consequences, this can lead to otherwise non-taxable benefits being considered taxable income.

#### ***§ 1.125-2 – General rules on elections***

**Making, Revoking and Changing Elections.** Generally, cafeteria plan elections must be made prior to the benefits becoming available, and elections must be irrevocable for the duration of the plan year, subject to the permissible change in status rules (which are included at § 1.125-4, which have not been modified and are not discussed here). An exception to the irrevocable election rule exists for contributions to an HSA, which employees may prospectively elect, revoke or change any time during the plan year with respect to salary not currently available at the time of the election.

**Elections Made by New or Rehired Employees.** In a significant clarification of a previously murky area, the proposed regulations permit cafeteria plans to provide employees with a 30-day window after their hire date to make an election, even if benefit choices are retrospective to date of hire. This rule does not apply to employees who have been terminated and rehired within 30 days or employees returning from a leave of absence of less than 30 days. This clarification should substantially simplify the enrollment of new or rehired employees.

**Electronic Elections.** New elections and revocations or changes in elections can be made electronically. Only the employee can make, change or revoke an election—a spouse or dependent may not make an election under a cafeteria plan and may not revoke or change an employee's election.

#### ***§ 1.125-5 – General rules on flexible spending accounts***

The three types of FSAs are dependent care assistance, adoption assistance and medical care reimbursement (health care FSA). FSAs remain largely unchanged by the new rules—the Uniform Coverage rule (requiring health FSA election amounts to be available at all times during the period of coverage) and the Use-It-or-Lose-It rule (prohibiting deferral of compensation) are still in effect. For health FSAs, the proposed regulations consider funds to be available even if reimbursements are made monthly and if the plan requires that claims reach a reasonable minimum (e.g., \$50) before being reimbursed.

**Forfeitures.** If an employee fails to use all contributions and benefits for a plan year before the end of the plan year (and the grace period, if applicable), those unused contributions and benefits are forfeited under the Use-It-or-Lose-It rule. The proposed regulations clarify that the employer sponsoring the cafeteria plan may keep forfeitures and use them for any reason, use forfeitures to defray expenses of administering the plan or allocate forfeitures among employees contributing through salary reduction on a reasonable and uniform basis. One important note: Some employers enter into agreements with certain employees to pay them an amount equal to forfeited FSA amounts, outside of the plan. The proposed regulations now warn, that the IRS will review these arrangements as part of its determination of whether the FSA is valid.

**HSA Compatible FSAs.** The new regulations confirm that limited-purpose health care FSAs and post-deductible health care FSAs may be offered through a cafeteria plan. Individuals covered by a limited-purpose or post-deductible health care FSA are eligible to contribute to an HSA. Those covered by a general-purpose health care FSA are not.

A limited-purpose health care FSA limits reimbursement to certain permitted benefits, such as dental or vision care. A post-deductible FSA limits reimbursement of medical expenses until the minimum annual high-deductible health plan's deductible is satisfied. Combinations of these two arrangements may also be used.

**Advance Payments for Orthodontia.** A cafeteria plan is permitted, but is not required to, reimburse employees for orthodontia services before the services are provided but only to the extent that the employee has actually made the payments in advance of the orthodontia services in order to receive the services. These orthodontia services are deemed to be incurred when the employee makes the advance payment. Reimbursing advance payments does not violate the prohibition against deferring compensation.

#### ***§ 1.125-6 – General rules on substantiation of expenses for qualified benefits***

The proposed regulations require that expenses are reimbursable only to the extent that they are incurred after the later of the effective date or adoption date of the plan. Similarly, if a plan amendment adds a new benefit, only benefits incurred after the later of the effective date or the adoption date are eligible for reimbursement. All expenses are required to be substantiated by a third-party independent of the employee and his or her spouse and dependents (substantiating only a limited number of total claims or only substantiating claims above a certain dollar amount does not satisfy the requirements of the new regulations). Note that the substantiation rules apply to all qualified benefits, not just FSAs.

**Debit Cards.** The rules for substantiation of expenses paid through a debit card generally follow the existing rules and now extend to dependent care FSAs as well. The rules are similar to those for health care FSAs, though expense reimbursements under a dependent care FSA are limited to the amount in the participant's account at the time, and expenses may not be reimbursed before the expenses are incurred (unlike advance payments for orthodontia).

#### ***§ 1.125-7 – Nondiscrimination rules***

Cafeteria plans are subject to complex nondiscrimination testing, designed to determine whether the plan favors in design or operation highly compensated employees. The IRS guidance

previously issued on testing has been scant, to say the least. The proposed regulations provide some guidance on this subject.

The nondiscrimination rules test whether a plan favors key employees and highly compensated employees (HCIs) over non-highly compensated employees (NHCIs). The proposed nondiscrimination tests are similar to those applied to 401(k) plans.

**Nondiscrimination Testing Requirement.** The proposed regulations reinforce that nondiscrimination testing must be performed annually for all cafeteria plans. Testing must be performed as of the last day of the plan year and must take into account all non-excludable employees (and former employees) who were employed on any day during the plan year. There are three nondiscrimination tests.

**Key Employee Test.** If a plan provides nontaxable benefits to key employees (as defined under Code section 416(i)(1)) in excess of 25% of the aggregate nontaxable benefits provided to all employees through the cafeteria plan, key employees will be taxed on the amounts that have been deducted from their pay on a pre-tax basis.

**Eligibility Test.** A cafeteria plan must not discriminate in favor of HCIs as to eligibility to participate. An HCI is any employee who, for the prior year (or current year if a new employee) is an officer, 5% shareholder, or an employee who received compensation greater than \$100,000 in 2007 (indexed for inflation) and is among the top 20 % of the employees ranked by compensation.

The examples provided in the new regulations make it clear that merely allowing all employees to participate in the cafeteria plan will not automatically make the plan nondiscriminatory. NHCIs must have the ability to elect the same plans and pay the same premiums as HCIs.

- Example 1. A plan that requires non-HCIs to pay \$10,000 per year for benefits while allowing HCIs to pay \$2,000 per year for benefits fails the eligibility test.
- Example 2. A plan that allows HCIs access to benefits that cost \$15,000 in employee contributions per year and limits non-HCIs access to a separate plan that costs \$8,000 per year also fails the eligibility test.
- Example 3. Same facts as Example 2, but both the HCIs and the non-HCIs pay \$8,000. Despite having both HCIs and non-HCIs pay the same premium, the plan fails the eligibility test due to the HCIs receiving a \$7,000 employer subsidy toward the cost of their plan.

**Contributions and Benefits Test.** A cafeteria plan must not discriminate in favor of HCIs as to contributions and benefits. This means that a plan must:

- give each similarly situated participant a uniform opportunity to elect qualified benefits, and the actual election of qualified benefits through the plan must not be disproportionate by HCIs; and

- give each similarly situated participant a uniform election with respect to employer contributions, and the actual election with respect to employer contributions for qualified benefits through the plan must not be disproportionate by HCIs.

Elections and employer contributions are each disproportionate if the HCI's ratio of aggregate qualified benefits to aggregate compensation exceeds the ratio of the NHCI's aggregate qualified benefits to aggregate compensation.

**Safe Harbor for Plan Providing Benefits.** A safe harbor test is available for plans that provide benefits limited to major medical coverage and exclude dental and health care FSA coverage. The safe harbor from the contribution and benefits test exists if contributions for each participant include an amount that either:

- equals the cost of the benefits selected by the majority of similarly situated HCIs; or
- is at least 75% of the cost of the highest cost benefits selected by any similarly situated participants.

Note that any contributions above the safe harbor must be proportionate to participants' compensation.

**Safe Harbor for Premium-Only Plans.** A cafeteria plan that offers the same benefits at the same cost to all HCIs and NHCIs is deemed to meet the nondiscrimination requirements. This safe harbor is not available for plans offering a health FSA.

**Permissive Disaggregation and Permissive Aggregation Rules.** Generally, an employer may aggregate plans for nondiscrimination testing purposes if the employer sponsors more than one cafeteria plan. Disaggregation is also permitted—a cafeteria plan may exclude employees who do not meet a minimum service requirement only if the plan requires three years of service to be eligible to participate; and, if less than three years of service is required, employees with less than three years of service must be included for nondiscrimination testing but may be considered as if they are covered under a separate plan. In other words, a cafeteria plan that provides benefits to employees who have not completed three years of service may test for discrimination as if there were two separate plans: one for employees who have completed three years of service and one plan for employees who have not completed three years of service.

Any employee who has completed three years of employment (and who satisfies any conditions for participation in the cafeteria plan that are not related to completion of a requisite length of employment) must be permitted to elect to participate in the cafeteria plan no later than the first day of the first plan year beginning after the date the employee completed three years of employment (unless the employee separates from service before the first day of that plan year).

## Conclusion

The proposed regulations clean up and consolidate the cafeteria plans rules and offer much-needed clarification. For many years, cafeteria plans generally have escaped close IRS scrutiny. This may be, in part, due to the relative dearth of guidance on nondiscrimination testing and that much of the guidance has never been finalized. We recommend that employers review their plans with benefits counsel and consider changes to ease plan administration and, in any event,

focus more of their housekeeping attention on their cafeteria plans. Once the rules are finalized, higher IRS scrutiny will likely follow.

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