

IRS Releases Proposed Cafeteria Plan Regulations

With little fanfare, the Internal Revenue Service (IRS) recently released new proposed cafeteria plan regulations. A few days later, it released final regulations that define, in part, the expenses that can be reimbursed by a cafeteria plan's dependent care flexible spending arrangement (DCAP). Neither set of rules makes fundamental changes to the requirements for cafeteria plans, but they do present substantial compliance challenges for employers.

While the new cafeteria plan regulations, with a few exceptions, are only proposed and not yet legally binding, the IRS took pains to demonstrate that the new rules primarily restate or clarify existing guidance. Therefore, employers would do well to implement some of the proposed rules sooner than the proposed effective date (the day the plan year starts in 2009). Unlike the cafeteria plan rules, the dependent care regulations are final and effective now, so employers should check that their DCAPs are in compliance immediately.

Background

Cafeteria plans provide important tax savings to employers and employees, but those tax savings are only available through programs that meet the tax code's cafeteria plan requirements. Since 1978, when cafeteria plans were first authorized, employers and their advisers have struggled to understand exactly how to maintain a cafeteria plan that meets the tax code requirements. Unfortunately, the tax code gives few specifics, and official IRS guidance has been issued piecemeal, leaving many unanswered questions.

While the new proposed cafeteria plan regulations do not answer all of the questions, they do replace a confusing patchwork of proposed and temporary

regulations and incorporate accumulated IRS guidance, both formal and informal. They also reflect the many statutory changes that have occurred since the IRS first issued proposed cafeteria plan regulations in 1984. For example, they reflect the change in the definition of *dependent* that was made by the Working Families Tax Relief Act of 2004 (for a discussion of this change, see Willis' *Employee Benefits Alert*, Issue 26).

It is important to note that final regulations have been in place for several years on two topics: mid-year cafeteria plan election changes and the interaction between cafeteria plans and the Family and Medical Leave Act. Nothing in the new proposed regulations revises these.

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The new dependent care rules are final versions of proposed regulations released last year. Most provisions were finalized with no substantive changes. See Willis' *Employee Benefits Alert*, Issue 72 for a detailed discussion of the proposed regulations and how they relate to reimbursable expenses under a DCAP.

No Fundamental Changes for Cafeteria Plans, But Many Items to Note

The cafeteria plan rules leave in place time-honored cafeteria plan fundamentals such as the use-it-or-lose-it rule (renamed the "use-or-lose" rule in the proposed regulations). They also include, however, many provisions, summarized below, that will be important to employers. Later in this *Alert*, we provide compliance suggestions on a few of those items that employers should consider implementing this year.

Changes Made By the Dependent Care Rules

The final dependent care expenses rules introduced a few notable tweaks to the proposed rules. For example, the final rules specify that summer school and tutoring programs are educational and therefore not reimbursable, but they also continue to provide that expenses for specialty day camps (e.g., computer camp) are reimbursable (provided certain conditions are met). Also, dependent care fees paid during short, temporary absences from work remain potentially reimbursable, but the fees need not be required in weekly or monthly increments (as specified in the proposed rules), so long as they are required during the absence. In addition, the final regulations add a stipulation that absences up to two weeks are considered short and temporary; longer absences may be deemed short and temporary depending on the circumstances.

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What Employers Need to Watch for on the Cafeteria Line

- **Cafeteria Plan Exclusivity.** A cafeteria plan election is generally the only means by which employees can avoid having adverse tax consequences from making certain benefit choices, including pre-tax premium payments, pre-tax contributions to health and dependent care flexible spending accounts, and pre-tax contributions to health savings accounts (HSAs).
- **Documentation Requirement.** Cafeteria plans, and any amendments to them, must be set out in writing. They do not provide any tax savings until the written document is adopted (or, if later, until the stated effective date of the plan or amendment).
- **Benefits for Non-Dependents (e.g., domestic partners).** If a cafeteria plan includes health benefits that are taxable because they are provided for individuals other than the employee's spouse and dependents, the benefits must be treated as if they were cash being paid to an employee – the employer must treat them as cash for withholding and payroll tax purposes.
- **Individual Insurance Premium Payments.** Cafeteria plans may include pre-tax payment of individual accident and health insurance premiums as a qualified benefit.
- **Group Term Life Insurance.** When group term life insurance in excess of \$50,000 is included in a cafeteria plan and paid for on a pre-tax basis, the amount to impute is determined solely by the Table I cost of the coverage instead of the greater of the Table I rate and the actual cost.
- **Paid Time Off.** A cafeteria plan may treat paid time off the same as vacation pay, but many elections relating to paid time off need not be made under a cafeteria plan.
- **Deferred Compensation Exceptions.** Cafeteria plans generally cannot provide any benefits that defer compensation, but several benefits can be included in a cafeteria plan even though deferred compensation appears to be involved.

- **Plan Years.** A cafeteria plan must have a 12-month plan year. Plan year changes or short plan years are allowed only for valid business purposes.
- **Charging Costs to Participants.** Cafeteria plans may collect reasonable costs of administration from plan participants as pre-tax payments.
- **New Employees' Elections.** Coverage elected under a cafeteria plan within 30 days of an employee's date of hire generally may be made effective retroactive to the date of hire, if the plan provides for that, but pre-tax deductions for that coverage cannot be effective with respect to compensation that is available on the date of the election.
- **Electronic Elections.** The rules under which pension plans must administer certain electronic notices and elections apply to cafeteria plans as a safe harbor for valid electronic cafeteria plan elections.
- **Substantiation.** All expenses paid or reimbursed by a cafeteria plan must be substantiated by a third party independent of the employee and his or her family members.
- **Debit Cards.** The new rules incorporate IRS guidance from 2006 on substantiating, paying and reimbursing expenses when payment for healthcare expenses is made with a debit, credit or stored value card (see *Employee Benefits Alert*, Issue 72 for a description of the rules for use of electronic payment cards, and see Willis' *FOCUS on Benefits*, February 2007 for a description of transition relief as plans move to those rules).
- **Nondiscrimination.** The new rules provide details on the requirement that cafeteria plans not discriminate in favor of highly compensated employees.
- **Spend-Down of DCAP.** A DCAP – but not a health FSA – may reimburse qualifying dependent care expenses incurred after termination of employment from amounts left in the DCAP.
- **Pre-Tax HSA Contributions.** Cafeteria plans may allow changes to pre-tax HSA contributions at any time and may restrict the number of such election changes so long as at least one change each month is allowed.
- **Coordination of Health FSAs and HSAs.** The new rules incorporate existing guidance on when participation in a health FSA makes an individual ineligible for HSA contributions (see *Employee Benefits Alert*, Issue 101 for a summary of IRS guidance on coordination of health FSAs with HSAs).
- **Qualified HSA Distributions.** The proposed regulations adopt existing rules and add new details on transfers from health FSAs to HSAs (see *Employee Benefits Alert*, Issue 102 for a discussion of IRS guidance on transferring health FSA balances to HSAs).

Documentation Requirement

Employer Action: Locate cafeteria plan documents; make sure the plan has been formally adopted and that the documents reflect plan operations and include all required provisions.

Timing: This year. The written document requirement appears in the tax code section that authorizes cafeteria plans.

Explanation: A cafeteria plan must be spelled out in writing and must include certain provisions. Without a plan document that includes the required provisions, there is no cafeteria plan, and employees offered an election are subject to tax on the

taxable items they could have elected. While the plan document requirement is not new, it is emphasized in the new rules.

Some new required plan provisions have been added. For example, the proposed regulations state that every cafeteria plan document must include statements that only employees may participate in the plan and that plan provisions apply uniformly to all participants. Plans that include FSAs and certain other benefits must include additional specific provisions.

The proposed regulations specify that the cafeteria plan document cannot be adopted retroactively. This means that the

cafeteria plan document must be adopted before the plan becomes effective, and the plan cannot provide benefits with respect to expenses incurred before the later of the effective date or the date of adoption. Amendments to the plan must also be in writing, adopted before they become effective, and not given retroactive effect. If amendments provide for new benefits, the plan cannot provide those new benefits with respect to expenses incurred before the later of the effective date of the amendments or the date of adoption.

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According to the proposed regulations, if a plan sponsor fails to comply with the written terms of the plan, then the plan fails to qualify as a cafeteria plan. This means that operational failures – apparently even minor operational failures – could result in an additional tax burden for employees, depending on their cafeteria plan elections. While these documentation, timing, and operation requirements are not entirely new, compliance with them may be a considerable departure from current practices for many employers.

Benefits for Non-Dependents

Employer Action: If an employee may elect health coverage for individuals other than his spouse or dependents under a cafeteria plan, ensure that the value of the benefit – to the extent not paid with after-tax employee contributions – is included in the employee's taxable pay on a current basis.

Timing: This year. Treating coverage for individuals other than employees' spouses and dependents as a taxable benefit is a long-standing IRS position.

Explanation: A cafeteria plan must provide a choice of at least one qualified benefit and at least one "permitted taxable benefit." A cafeteria plan cannot, however, provide any benefits other than qualified benefits and permitted taxable benefits. Benefits that an employer provides for an individual who is neither the employee's spouse nor dependent (e.g., a domestic partner or ex-spouse) generally are not excluded from the employee's taxable pay and are not qualified benefits. Therefore, such benefits cannot be elected under a cafeteria plan except as permitted taxable benefits.

The proposed regulations specify that a cafeteria plan may allow as a taxable benefit an election of accident or health coverage for an individual who is not the employee's spouse or dependent. The

proposed regulations incorporate previous IRS guidance by defining a permitted taxable benefit as cash and certain other taxable items that are equivalent to cash. Under the proposed regulations, a taxable benefit, such as non-dependent health coverage, is equivalent to cash if (1) the employee pays for it with after-tax contributions, or (2) the benefit is treated for tax purposes (including reporting and withholding) as if the employee received cash compensation equal to the value of the benefit and then immediately purchased the benefit with after-tax employee contributions. More simply, when a taxable benefit is provided, each paycheck should include a ratable portion of the benefit's value as part of the employee's taxable pay (except insofar as the employee actually paid for the benefit with after-tax contributions).

A note of caution: Some items cannot be included in a cafeteria plan even if they are equivalent to cash. Those items include long-term care insurance, life insurance on the life of anyone other than the employee, and fringe benefits (e.g., qualified transportation benefits).

Individual Insurance Premium Payments

Employer Action: Discontinue any provision that allows employees to pay any insurance premiums – including COBRA premiums – using their health FSAs. If the cafeteria plan allows pre-tax payment of individual health insurance or COBRA premiums, consider discontinuing that provision in light of potential compliance problems.

Timing: This year. Prohibiting use of health FSAs to pay insurance premiums is a long-standing IRS position. Similarly, the compliance issues that apply when individual or COBRA premiums are paid through or reimbursed by a cafeteria plan merit prompt attention.

Explanation: Over the years, questions have arisen on whether a cafeteria plan can offer employees the choice of using pre-tax amounts to purchase individual accident insurance, health insurance, or COBRA coverage under another employer's plan. The proposed rules continue the explicit prohibition against using health FSAs to pay any insurance premiums. The new proposed regulations confirm that cafeteria plans can allow employees to elect individual accident or health insurance coverage that they own, or elect COBRA coverage under which they are covered employees. The proposed rules do not clarify, however, whether an employee can make pre-tax payments of premiums on an individual policy owned by his spouse (or on COBRA coverage for which the spouse is the covered employee). The proposed regulations do not address issues that arise under other laws when pre-tax amounts are used to purchase individual insurance coverage or COBRA under another employer's plan. Specifically, allowing pre-tax payment of

insurance premiums through a cafeteria plan may cause the insurance or COBRA coverage paid for with pre-tax amounts to be an ERISA plan sponsored by the employer maintaining the cafeteria plan. If that happens, and the coverage paid for with the pre-tax amounts provides reimbursement of healthcare expenses, then that coverage will be required to comply with HIPAA, COBRA and other federal mandates. Because of this, even though the proposed rules approve pre-tax payment of individual and COBRA premiums, it would be advisable for employers to avoid such arrangements.

Group Term Life Insurance

Employer Action: For group term life insurance in excess of \$50,000 that is purchased through a cafeteria plan, impute income based only on Table I rates (instead of the higher of Table I rates vs. actual cost).

Timing: As of August 6, 2007; i.e., *now*.

Explanation: Group term life insurance coverage up to \$50,000 is nontaxable and is a qualified benefit for cafeteria plan purposes. It has always been permissible to include coverage in excess of \$50,000 in a cafeteria plan as a *taxable* benefit. Under previous IRS guidance, however, if an employee paid for his excess coverage with pre-tax contributions under a cafeteria plan, an anomalous tax result applied. The employee could end up paying more taxes on the excess coverage than he would have if the employer paid for the excess coverage. The proposed regulations change this rule. If excess coverage is paid for with pre-tax contributions, the amount imputed to the employee would be based exclusively on Table I rates. In addition, the taxable amounts need not be included in the employee's income on a current basis. As with employer-paid coverage, the taxable amounts could be included in the employee's taxable pay at any time before the end of the year.

Paid Time Off

Employer Action: Remove paid time off from the cafeteria plan, unless the plan allows employees to elect more nontaxable benefits by foregoing paid time off or provides that flex credits may be applied to purchase either paid time off or nontaxable benefits.

Timing: Next plan year (2008, for most). Unnecessarily including paid time off in a cafeteria plan presents the risk that the paid time off might be carried over into future years inadvertently, in which case it would disqualify the cafeteria plan.

Explanation: Previous guidance provided rules for elections to buy or sell vacation days under a cafeteria plan, but the guidance was silent about elections affecting other types of paid leave. As a result, it was unclear whether paid leave that includes a sick pay benefit could be elected under a cafeteria plan. The proposed rules confirm that all paid time off (including vacation days, sick days and personal days) can be bought and sold in the same way as vacation days for cafeteria plan purposes.

The proposed rules state that a program offering only cash or paid time off is not a cafeteria plan at all and need not comply with the cafeteria plan rules. Therefore, unless an employee can elect to trade paid time off for nontaxable benefits or can use cafeteria plan flex credits to purchase paid time off, it generally is not necessary to include the paid time off in a cafeteria plan. An employer need not comply with the cafeteria plan rules if it offers a program under which employees can elect:

- To accept reduced pay in exchange for additional days of paid time off
- To accept fewer days of paid time off in exchange for increased pay

If paid time off is purchased under a cafeteria plan, the plan must preclude any employee from using the elected paid time off – or receiving cash for it – in a subsequent plan year. In addition, the 2 1/2 month grace period that a cafeteria plan may adopt with respect to other benefits may not be adopted with respect to paid time off.

Exceptions to Deferred Compensation

Employer Action: Review cafeteria plan benefits to see if any are provided beyond the year for which the employee elected the benefit.

Timing: This year. The deferred compensation prohibition appears in the tax code's cafeteria plan provisions.

Explanation: Generally, cafeteria plans may not operate in any manner which permits employees to defer the receipt of compensation. For example, if a plan allowed participants to use contributions for one plan year to purchase a benefit in a subsequent plan year, the IRS would deem it a prohibited deferral. Over the years, however, the IRS has issued various rulings clarifying the scope of the deferred compensation prohibition. For example, plans that grant a premium waiver during disability will not run afoul of the rule. The proposed regulations incorporate this guidance, as well as certain informal guidance.

- A health FSA may reimburse participants for orthodontia payments that are made before the orthodontia services begin if the payments are made as a condition of obtaining the services, and reimbursement of the prepayments will not be treated as deferral, even if the services are provided in a later year.
- Dental and vision plans can have a mandatory two-year election so long as the premiums for each plan year are paid no less frequently than annually and the cafeteria plan does not use salary reduction or flex credits from the first plan year to pay for second year premiums.
- Salary reduction amounts taken during the last month of the plan year can be applied on a uniform and consistent basis to pay the insurance premiums for the first month of the immediately following plan year (e.g., under a calendar year plan, salary reductions taken in December may be used to pay insurance premiums for January coverage).

Conclusion

The IRS has requested comments on its proposed cafeteria plan regulations, and indications are that it will get a vigorous response. Some have noted that although the proposed regulations are a big improvement over the previous guidance, many questions remain unanswered. Willis' Legal & Research Group, through its participation in industry organizations, will be offering comments on these proposed regulations and welcomes your thoughts on cafeteria plan issues.

If you wish to pass on a comment, get additional information, or explore how the proposed rules affect your particular benefits plan, we invite you to contact a Willis Associate. Our professionals can help you to navigate the murky cafeteria plan waters.

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