eActionAlert

Funding of Employee Health & Welfare Benefits by Internal Revenue Code (IRC) Section 125 Cafeteria Plans

November 13, 2007

After more than 23 years of piecemeal guidance on cafeteria plans, the Internal Revenue Service (IRS) recently issued new proposed Regulations under Section 125 of the Internal Revenue Code of 1986 (the "Code"). The new proposed Regulations consolidate into one set of rules the numerous IRS interpretations issued over the past couple of decades in response to the continuingly changing federal tax laws. The old proposed and temporary Regulations have been withdrawn; therefore, employers must rely on the new proposed rules pending issuance of final Regulations, which will be effective January 1, 2009.

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Introduction

The new proposed Regulations begin with general rules on qualified and nonqualified benefits and then set forth procedures for valid elections. They then state new rules for flexible spending arrangements which allow employees to pay for unreimbursed health care, dependent care or adoption assistance on a pre-tax basis subject to the "use it or lose it" mandate. The rules conclude with a discussion of the substantiation of accident and sickness claims to be reimbursed on a pre-tax basis and of the new nondiscrimination provisions for eligibility and benefits.

General Rules

A nondiscriminatory cafeteria plan is the exclusive means by which an employer may offer employees a choice between taxable and nontaxable benefits without the choice itself resulting in taxable income to participants.

A cafeteria plan must be in writing and be operated in accordance with its written terms. The document must describe the plan's eligibility requirements, all benefits, procedures for making elections, how participants and the employer make contributions, the maximum amount of such contributions and the plan year (which must be 12 consecutive months, subject to special rules for a short plan year and the changing of plan years).

The plan may cover only employees (including leased employees) and former employees (including laid-off and retired employees) but it must not be maintained predominantly for former employees. Self-employed individuals, sole proprietors, partners, corporate directors and 2% shareholders of S corporations are not treated as employees. Hence, they may not participate in a cafeteria plan. However, some individuals have a dual status (such as employee and director) and the new proposed Regulations provide rules for their participation. A self-employed individual or a partnership may sponsor a cafeteria plan for its employees.

These plans must offer employees, including those receiving severance pay, a choice between at least one permitted taxable benefit (such as cash from current compensation, severance pay or paid time off) and at least one "qualified benefit," that is excludible from employees' gross income under a specific provision of the Code. Examples of qualified

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benefits are contributions to a 401(k) plan, group term life insurance (up to $50,000), employer-provided accident and health plans, medical reimbursement plans, LTD and STD benefits, COBRA continuation premium payments withheld from severance pay, dependent care assistance programs and adoption assistance programs.

The new proposed Regulations continue to prohibit the deferral of compensation from one cafeteria plan year to a later cafeteria plan year. There are some exceptions, such as paying 401(k) deferrals, contributing to a Health Spending Account ("HSA") and, for employees of certain educational institutions, paying premiums now for post-retirement group term life insurance through a Section 125 plan. Certain health plan features that apply for more than one plan year, such as lifetime limits on benefits, premium waiver during disability and a daily rate paid for hospitalization, do not constitute deferred compensation.

A cafeteria plan must not offer scholarships, educational assistance benefits, employer-provided meals or lodging, long-term care or insurance, fringe benefits, contributions to an Archer Medical Savings Account or elective deferrals to a section 403(b) plan.

A cafeteria plan may provide for a 2-½ month grace period (which can be shorter at the employer's election) immediately following the end of the plan year; thus, extending the period for incurring claims. Unused benefits for one qualified benefit cannot be used to reimburse expenses incurred as another qualified benefit. Benefits not used by the end of this permissive grace period are forfeited under the use it or lose it rule.

Accident and health coverage may not be extended on a pre-tax basis to persons other than an employee's spouse and dependents as defined in Code Section 152.

Group term life insurance coverage in excess of $50,000 may be provided through a cafeteria plan. The new proposed Regulations provide that the taxable cost for the excess coverage is determined exclusively by using Table I of the Regulations under Code Section 79.

Cafeteria Plan Elections

Generally, elections must be made annually and prior to their being effective. They are usually irrevocable through the end of the plan year except if the employee experiences one of the specified changes of status (such as divorce), if the plan so provides.

One exception is if HSA contributions are made through a cafeteria plan, employees may elect, revoke or change their salary reduction elections for HSA contributions at any time during the plan year.

A cafeteria plan is permitted to include an automatic election to participate (similar to that which may be used for 401(k) plans). The plan may also provide for default elections to be applicable to both new and continuing employees (e.g., prior year elections to be continued).

A new employee may make an election, within 30 days of hire, which is retroactive to date of hire. This allows new employees to avoid including a month's benefits in gross income.

Employee elections may be made electronically. A safe harbor is available, based on the IRS Reg. §1.401(a)-21 safe harbor for qualified plans.

Flexible Spending Arrangements (FSAs)

There are now three types of FSAs: health, dependent care and adoption assistance.

The maximum amount of reimbursement available to an employee should be less than 500% of the combined employee salary reductions and employer flex credits (non-elective employer contributions made to the cafeteria plan) for that employee.

Health FSAs must provide that the amount elected prior to effective coverage is eligible for reimbursement at all times during the plan year, net of reimbursements previously made during the year. (This rule does not apply to dependent care or adoption assistance FSAs.)

Under all types of FSAs, in order to meet the non-deferral of income rule, all benefits and contributions must be used by the end of the plan year (or by the end of the grace period if the plan provides for one). Thus, the use it or lose it rule applies to all types of FSAs.

The employer may retain any forfeitures, use them to pay plan administrative expenses or allocate them among FSA participants.

A "limited purpose" health FSA and/or a "post-deductible" FSA may pay contributions to an employee's HSA, but only for an eligible employee covered by a "high deductible health plan."

A dependent care FSA may pay expenses incurred after termination of employment.

A plan also may allow immediate reimbursements from a health FSA with respect to orthodontia expenses paid before the services are rendered.

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Substantiation of Expenses

The substantiation rule applies to reimbursement of all qualified benefits offered under a cafeteria plan.

All expenses covered under the plan must be substantiated before they are reimbursed. Substantiation of a percentage of claims or only of claims above a certain dollar amount does not satisfy this rule.

In each instance, reimbursement for medical care or for other medical expenses (as defined in Code Section 213) must be for services rendered or for purchases made during the current coverage period.

Likewise, reimbursements for dependent care are allowed only for services rendered during the current coverage period. At the employer's option, the plan may reimburse dependent care expenses incurred after a participant's employment ends but during the plan year (or grace period, if applicable) if there are any unused benefits in the participant's account.

All claims must be substantiated by information received from a third-party which is independent of covered employee and dependents. There are special rules for limited-purpose health FSAs coexisting with HSAs and post-deductible health FSAs.

There are detailed mandatory rules regarding the use of debit cards to pay or reimburse medical expenses incurred at medical care providers or at pharmacies or other stores. These rules generally follow prior IRS guidance (see Revenue Ruling 2003-43 and Notices 2006-69 and 2007-2). However, deactivation of the card is required only after participation in the cafeteria plan ceases, as opposed to when employment ends.

Nondiscrimination Rules

A cafeteria plan cannot discriminate in favor of highly compensated individuals ("HCIs") as to eligibility. Nor can it favor highly compensated participants ("HCPs") regarding contributions or benefits. There are tests to determine whether a plan satisfies these rules as well as safe harbor provisions. There is also a "key employee test." Testing must be done as of the last day of the plan year and takes into account all non-excludible employees and former employees who were actively employed on any day during the plan year.

Under the eligibility test, an HCI is an individual who is an officer, a 5% owner or highly compensated. If the ratio of HCIs benefiting under the plan is too high compared to the ratio of Non-HCIs benefiting under the plan, the plan is considered to be discriminatory unless it satisfies a facts and circumstances test.

Under the contributions and benefits test, a cafeteria plan must give similarly situated participants the same opportunity to elect tax-free benefits; HCPs, compared to Non-HCPs, must not disproportionately elect such benefits. There is prohibited discrimination if the elections made by the group of HCPs, measured as a percentage of their aggregate compensation, exceeds such elections by the group of Non-HCPs, measured as a percentage of their combined compensation.

Under the key employee test, if the tax-free benefits provided to key employees exceed 25% of the aggregate tax-free benefits provided to all employees during the plan year, each key employee must include in his gross income an amount equal to the maximum non-taxable benefits he could have elected, even if he elected only taxable benefits.

There is a safe harbor for health plan benefits and contributions if, for example, the contribution made for all participants equals 100% of the cost of health benefit coverage for the majority of HCPs who have similar coverage (such as individual coverage or family coverage).

There is a different safe harbor for "premium conversion plans," which is defined as a cafeteria plan that offers as its sole benefit a choice between cash compensation and payment of the employee's share of accident and health insurance premiums on a pre-tax basis. Under the safe harbor, if such a plan satisfies the eligibility test, it is deemed to pass the contributions and benefits test.

What this Means to You and M&A's Recommended Actions

With the assistance of your M&A Senior Consultant and/or Health & Welfare Specialist, you should promptly review your Cafeteria Plan provisions for possible changes, whether permissive or mandated.

M&A is an employee benefit consulting and management firm and, as such, we do not practice law. If you have any questions about cafeteria plans, please contact your Senior Consultant or Health & Welfare Specialist at (877) 564-4300.

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