

Benefit Brief



SUBJECT: New IRS Regulations on Cafeteria Plans

DATE: September 2007

This Benefit Brief discusses new IRS Regulations on Cafeteria Plans (Section 125 plans) and what employers should do to ensure their current plans are in compliance.

The IRS has proposed new regulations for cafeteria plans that update, replace, and consolidate existing regulations and provide guidance for implementing and administering the plans. These proposed regulations, after the draft is issued, are expected to be effective for plan years beginning on or after January 1, 2009. However, employers may immediately rely on these proposed regulations for guidance on managing their plans.

What are Cafeteria Plans?

Cafeteria Plans allow employers to offer certain benefits to employees on a pre-tax basis. The employees agree to reduce their pay in exchange for benefits, which are elected before the start of the plan year. Employers must comply with Internal Revenue Code requirements when establishing and operating cafeteria plans to ensure that they are valid and to prevent qualified benefits from becoming taxable to employees.

What are the Proposed Provisions?

The following are highlights of the proposed regulations:

Qualified Benefits - A cafeteria plan must offer a choice between at least one taxable benefit (see discussion below) and one qualified benefit. These qualified benefits include medical, dental, vision, and disability insurance, health FSA, contributions to an HSA, premiums for an employee's COBRA coverage or individual health coverage, group term life insurance (up to \$50,000), dependent care assistance, and adoption assistance plans.

Permitted Taxable Benefits - A cafeteria plan must provide a choice of at least one taxable benefit. The new regulations clarify that these choices can include cash (the employee's regular salary), annual leave, sick leave, paid time off, or severance pay.

Non-Qualified Benefits - The following benefits cannot be offered through a cafeteria plan: dependent life insurance coverage, long-term care insurance, educational assistance benefits, and transportation benefits. Including one of these benefits will result in disqualification of the entire plan.

Written Plan Document Requirement - A cafeteria plan that is not in writing and that does not include all required information does not qualify as a cafeteria plan and all benefits that are provided will be subject to taxation to employees as income. The proposed regulations provide guidance on what information must be included in the written document. The plan must describe all benefits, periods of coverage, rules for eligibility to participate, procedure for making elections, how employer contributions may be made, and the maximum amount of elective contributions. Amendments must also be in writing and must be adopted prior to their initial effective date.

Non-Discrimination Rules - A cafeteria plan is prohibited from discriminating against non-highly compensated employees. The proposed rules clarify the methods of conducting the non-discrimination tests. The definition of highly compensated has been revised to an officer or more-than-5% shareholder, an individual or participant who had compensation during the prior year (or in the current year for new employees) in excess of the specified amount (\$100,000 in 2007), and a spouse or dependent of the above. Nondiscrimination testing must be performed annually. The regulations provide guidance for nondiscrimination testing on eligibility, contributions, and benefits. A safe harbor provision has been added for premium-only plans.

Participation Limited to Employees - The new regulations clarify that only employees can participate in a cafeteria plan, although spouses and dependents can benefit from the employee's participation. Self-employed individuals, partners, 2% shareholders in an S-corporation, and directors are not employees so they are not eligible to participate.

Optional Election for New Employees - The proposed regulations now permit new employees, who are eligible for participation on the date of hire, to elect to participate within 30 days of the date of hire with benefits starting on the date of hire. This rule does not apply to employees who leave employment and then return within 30 days.

Substantiation of Expenses - The rules require that all claims be substantiated with proof from an independent third party that identifies the product or service. Employees must certify that the expense has not been reimbursed and that they will not seek other reimbursement for the expense.

Orthodontia Expenses - Claims for an FSA can now include advance payments for orthodontia as long as substantiation is provided, and the plan allows for this reimbursement.

Plan Year - Cafeteria plans are now permitted to change their 12-month plan year for a "valid business purpose." Examples include changing to a calendar year health plan and wanting the cafeteria plan year to coincide, and changing to a new insurance policy in the middle of the plan year.

New Imputed Income Calculation for Life Insurance - Group term life insurance provided through a cafeteria plan that is in excess of \$50,000 is taxable and must be included in the employee's gross income (imputed income). Employees are now taxed at the Table 1 rate for any coverage over \$50,000. (Table 1 is used by the IRS to calculate the value of employer-provided life insurance). This provision is effective immediately.

Administrative Expenses - Administrative expenses of the plan, such as HSA administration fees, can be paid for with salary reductions that are excluded from income.

What Should an Employer Do?

All employers with cafeteria plans should take the following steps to ensure that their plans are in compliance:

- Review all cafeteria plan documents to see if changes need to be made or if any changes are desired. Make sure the plan is being administered in the way the plan document states. Remove any nonqualified benefits from the plan. Contact Benecon with questions, to develop a compliance plan of action, or to make changes.
- Review the methods you use to perform nondiscrimination testing of your cafeteria plan, or begin performing nondiscrimination testing if you have not been doing it. Use the new rules for guidance with this testing.
- Communicate any plan changes to your employees.

- If you provide life insurance through your cafeteria plan, use the new method to calculate the cost of excess coverage for your employees. Notify your payroll department that this provision went into effect on August 6, 2007.

The IRS is accepting comments on the proposed regulations until November 5, and will hold a hearing on the new rules on November 15. The IRS has not specifically announced that it will increase enforcement of cafeteria plan regulations, however it seems likely it will once the rules are finalized.

If you have questions about the proposed new regulations or complying with these rules, please contact Danielle Omans at The Benecon Group, Inc. at domans@benecon.com or the number shown below.

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