

# Compensation & Employment Law Practice Group

## Client Alert

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### Action May be Required by December 31, 2008 to Comply with Proposed Cafeteria Plan Regulations

On August 6, 2007, the Internal Revenue Service (“IRS”) issued new proposed regulations governing the operation of cafeteria plans under Section 125 of the Internal Revenue Code of 1986, as amended (the “Code”). These regulations replace earlier proposed and temporary regulations, and consolidate law changes and guidance issued by the IRS over the past twenty years. The regulations preserve much of the existing guidance but clarify some outstanding issues and include a few new rules. Existing cafeteria plan regulations governing mid-year election changes and coordination of family and medical leave with cafeteria plan coverage remain the same.

The proposed regulations generally are effective for plan years beginning on and after January 1, 2009, and may be relied on until final regulations are issued. Although final regulations will not be issued until some time next year, *plan sponsors must have a written cafeteria plan in place by January 1, 2009*. In addition, plan sponsors are encouraged to review their current plan documents by January 1, 2009 and consider adopting any required or optional provisions set forth in the proposed regulations.

### Highlights of the New Proposed Regulations

Highlights from the new proposed regulations include the following:

- **Written Plan Requirements** – The new proposed regulations provide that a cafeteria plan must be in writing, and must offer participants a choice between a taxable benefit (for example, cash, including salary reductions) and at least one qualified benefit (*i.e.*, the benefit is excludable from the employees’ taxable income under a specific section of the Code). The written plan document must be in place by January 1, 2009, may consist of, and cross reference multiple documents<sup>1</sup>, and should include the following specific items:

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<sup>1</sup> The exact terms and provisions of the benefits made available through the cafeteria plan are not required to be set forth in the cafeteria plan. Rather, such terms and provisions may be incorporated by reference through the governing documents under which the benefits are offered, such as a welfare benefit plan or flexible spending account plan.

- ⌘ a description of the benefits offered through the plan;
- ⌘ the rules governing participation, including the requirement that only employees may participate in the plan;
- ⌘ the procedure for making elections and contributions under the plan;
- ⌘ the plan's grace period, if applicable;
- ⌘ the plan year;
- ⌘ how employer contributions may be made under the plan;
- ⌘ the maximum amount of elective contributions available to any employee through the plan;
- ⌘ state that all elections are irrevocable (except to the extent the plan incorporates the Code's change-of-status rules);
- ⌘ if the plan includes a flexible spending account ("FSA"), the provisions complying with the uniform coverage rules and the use-it-or-lose-it rule; and
- ⌘ for health savings accounts ("HSAs"), the ability to elect to make salary reduction contributions to an HSA, to change such election prospectively at any time, and if applicable, the ability to transfer FSA funds to an HSA.

Failure to satisfy the written plan requirements or to operate the plan in accordance with the written document, Code Section 125, or the regulations will result in the plan failing to be a cafeteria plan. As a result, employees will be taxed on the value of the benefits elected under the plan. Moreover, there is currently no IRS or DOL correction program (equivalent to EPCRS or the VFPC) available to plan sponsors who want to correct any plan or operational failures to preserve the tax benefits of participants. It is hoped that this issue will be addressed in future guidance or in the final regulations.

## **New Plan Design Features**

- **Optional Election for New Employees.** A cafeteria plan may provide that new employee coverage elections made within the first 30 days of employment can be retroactively effective as of the date of hire, provided the employee is eligible to participate on the date of his or her hire.
- **Automatic Elections.** A cafeteria plan may provide that new employees or current employees who fail to make a timely cafeteria plan election may be enrolled in a default election for one or more qualified benefits.
- **COBRA Premiums.** A cafeteria plan may allow pre-tax premium payment of COBRA premiums under a former employer's plan. In addition, former employees of the employer sponsoring the cafeteria plan may use severance pay to pay for COBRA premiums on a pre-tax basis.
- **Individual Accident and Health Policy Premiums.** A cafeteria plan may offer employees the ability to pay for individual health insurance policy premiums for single or family coverage on a pre-tax basis.
- **Health Coverage for Non-Spouse/Non-Dependent.** Employees may elect health coverage for an individual who is not an employee's spouse or tax dependent (such as a former spouse or domestic partner) through the cafeteria plan on an after-tax basis. The fair market value of the coverage must be included in the employee's gross income.

- **Electronic Elections.** The proposed regulations make the Code’s electronic election safe harbor available to cafeteria plans, permitting employees to use electronic media to make elections.
- **Requirements for FSAs.** The new proposed regulations continue in effect the use-it-or-lose-it rule, the limit on the maximum amount of reimbursement permitted, and the requirement that, for a health FSA, the maximum amount of reimbursement must be available at all times. Notable changes under the proposed regulations relating to FSAs include the following:
  - ⊠ **Spend Down Option for Dependent Care FSAs.** A dependent care FSA may reimburse an employee for dependent care expenses incurred after the date an employee ceases participation in the cafeteria plan (for example, after termination of employment) and through the last day of the plan year (or grace period immediately after the plan year, if applicable).
  - ⊠ **Adoption Assistance FSAs.** Adoption assistance FSAs are included as a qualified benefit that may be offered through a cafeteria plan.
  - ⊠ **Forfeitures.** Forfeitures or “experience gains” from participants’ FSAs may be (i) retained by the employer; (ii) used to defray administrative expenses incurred by the plan; (iii) used to reduce salary reduction contributions for the next year on a “reasonable and uniform basis”; or (iv) returned to employees on a “reasonable and uniform basis.” The retention of forfeited employee contributions may conflict with the requirements of ERISA under certain circumstances and, therefore, plan sponsors may want to consult with ERISA counsel prior to implementing this feature.
  - ⊠ **Qualified Reservist Distributions.** The Heroes Earnings Assistance and Relief Act of 2008 amended Section 125 of the Code to permit a cafeteria plan to provide for a distribution of the unused amounts in the healthcare FSA accounts of employees who are called to active duty which lasts longer than 180 days. This provision is effective for distributions made after June 18, 2008.
- **Limited-Purpose Health FSAs and Post-Deductible Health FSAs.** The new proposed regulations incorporate earlier guidance permitting HSA-compatible limited-purpose health FSAs (only pays or reimburses permitted coverage benefits, such as vision care, dental care or preventive care) and post-deductible health FSAs (reimburses only preventive care expenses or medical expenses incurred after the minimum annual deductible under an HSA-compatible high deductible health plan has been satisfied) to be offered through a cafeteria plan. The regulations also contain a new rule which provides that a health FSA could also be structured as a combination limited-purpose/post-deductible health FSA, in which the health FSA functions as a limited purpose arrangement until the minimum annual deductible is satisfied, and then the FSA converts to a general purpose FSA.
- **Grace Period Requirements.** A cafeteria plan may extend the period for incurring expenses for qualified benefits by including a grace period immediately following the end of each plan year. The grace period may extend

to the 15<sup>th</sup> day of the 3<sup>rd</sup> month after the end of the plan year. Any unused contributions from the preceding plan year that exceed expenses incurred during the grace period may not be carried forward to a later plan year, may not be cashed out, and must be forfeited under the use it or lose it rule.

- **Group-term Life Insurance.** Effective August 6, 2007, the cost of employee group-term life insurance coverage in excess of \$50,000 must be included in an employee's gross income. The proposed regulations change the method of calculating the cost of group-term life insurance coverage in excess of \$50,000, and provide new examples of how to calculate the inclusion.
- **Health Savings Accounts.** Contributions may be made to an HSA on a pre-tax basis through a cafeteria plan, provided the written cafeteria plan document:
  - ✧ specifically describes the HSA contribution benefit;
  - ✧ allows a participant to make prospective election changes; and
  - ✧ allows a participant who becomes ineligible to make HSA contributions to prospectively revoke his or her salary reduction election for HSA contributions.
- **Nonqualified Benefits.** Nonqualified benefits (such as group-term life insurance for an employee's spouse, child or dependent, long-term care insurance, scholarships, educational assistance, and fringe benefits) can not be offered through a cafeteria plan, even if they are paid for with after-tax contributions.
- **Debit Cards.** The new proposed regulations incorporate previously issued guidance on the use of a debit card to pay, substantiate and reimburse qualified expenses. Among the permissible substantiation methods are copayment matches, recurring expenses, and real-time substantiation. The new proposed regulations also allow point-of-sale substantiation through matching inventory information.
- **Nondiscrimination Requirements.** The new proposed regulations provide additional guidance and clarity on the nondiscrimination rules under Code Section 125. In particular, the regulations define key terms including highly compensated individual or participant, key employee, officer, and 5% shareholder. The regulations provide guidance on the eligibility nondiscrimination test by incorporating the reasonable classification, safe harbor percentage and unsafe harbor percentage tests under Code Section 410(b). Additionally, for purposes of the contribution and benefits test, the regulations provide a new objective test to determine when the actual election of benefits is discriminatory. The proposed regulations provide that a cafeteria plan must give each similarly situated participant a uniform opportunity to elect qualified benefits, and that highly compensated participants must not actually disproportionately elect qualified benefits. The new proposed regulations also add a safe harbor for premium-only plans that satisfy certain requirements.

## **Action Items**

Employers must bring their written cafeteria plans into compliance with the new proposed regulations by January 1, 2009. To comply with the new proposed regulations, employers should:

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- adopt a written cafeteria plan if one is currently not in place;
- review their cafeteria plan documents to determine if an amendment is necessary to comply with the written plan requirements (for example, long-term care and any other impermissible nonqualified benefits should be removed from the cafeteria plan before the effective date);
- consider whether the plan's administration violates any of the new proposed regulations;
- review the new optional provisions that may be included in a cafeteria plan and determine whether it wishes to implement any such provisions;
- review group life insurance policies and ensure that the cost of group life insurance is correctly included in the income of participating employees using the new formula provided in the proposed regulations when preparing their 2008 W-2 forms;
- contact any third party administrators to ensure that the administration will include amendments and procedures necessary to comply with the proposed regulations (particularly the new discrimination testing regulations); and
- perform annual discrimination testing in accordance with the new proposed regulations.

For more information regarding the proposed cafeteria plan regulations, please contact any of the individuals listed on this Client Alert.

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