



New Cafeteria Plan Regulations – 1.125-1 PART 2

To jog your memory, this is the second in a series of reports on the five new Internal Revenue Service (IRS) regulations affecting cafeteria plans.

As you read through the seemingly endless, dull list of dos and don'ts in this series of articles, you might be wondering how these regulations came about. The fact is that many of these regulations came from questions asked by participants or plan service providers. And the most efficient way of conveying the answers to these questions was to simply list them out in a regulation to codify and make permanent the IRS's view on such matters.

We know this is dull reading, but it's important information for employers, consultants to employer groups, and administrators of cafeteria plans. We'll do our best to continue to pass on the essence of the remainder of this regulation in as concise and brief a version as possible. As a reminder, the 1.125-1 Regulations reflect on qualified and nonqualified benefits in a cafeteria plan.

Each regulation is divided into sections with the different sets of regulations containing a differing number of sections. Regulation 1.125-1 contains a whopping 18 distinct sections. This article reports on the last 12 segments.

7. Only employees may participate in a cafeteria plan. The term "employee" includes common law employees, leased employees, full-time life insurance salesmen, and current or former employees. The term "employee" does not include a self-employed individual or a more than 2% shareholder of an S corporation. A sole proprietor, a partner in a partnership, or a director who is not otherwise providing services to the corporation are not considered employees for purposes of participating in a cafeteria plan.

Selling or acquiring stock in the middle of a plan year affects the eligibility of the stockholder for the entire plan year. If at any time during the plan year a shareholder owns more than 2% of the employer, they will be deemed to be ineligible to participate in the plan for that year.

Various other rules were reiterated within the new regulations. Although former employees may participate in the plan, the plan cannot be established just for former employees. Also, spouses and dependents may not actively participate (elect or purchase benefits) in the plan, but they may benefit from the plan through the participant's involvement. And, employees of certain controlled groups will be treated as employed by a single employer.

8. Benefits may be purchased with after-tax employee contributions. Benefits such as health coverage for an individual that is not a spouse or dependent and disability coverage may be paid with after-tax dollars.

9. Prohibited taxable benefits. However, not just any taxable benefit can be included in a cafeteria plan – just those listed at the beginning of the regulation. These were discussed in the previous article. A plan that offers taxable benefits other than the taxable benefits described is not a cafeteria plan. In short, that means that all benefits will become taxable under a plan that offers non-qualified benefits.

10. Rules under all code sections must be satisfied in order for the benefits to remain non-taxable. Benefits offered through a cafeteria plan derive their exclusion from income in other IRS code sections. For instance – Internal Revenue Code (IRC) Section 129 describes the exclusion from income for certain dependent care expenses. Offering this benefit through a cafeteria plan keeps the expenses non-

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taxable and allows for salary redirection. However all the rules of the original code section must be satisfied before being included in a cafeteria plan.

Code Section 125 has its rules too. If the nondiscrimination rules of IRC Section 125 are not satisfied, all the qualified benefits selected by highly compensated and/or key employees will be included in their gross income. And if a benefit is taxable before being offered through a cafeteria plan, it will continue to be a taxable benefit even though it is offered through a cafeteria plan.

11. A cafeteria plan may offer group-term life insurance coverage that is in excess of \$50,000. The premium payment for \$50,000 of group-term life insurance may be paid with pre-tax dollars. The excess premium for aggregate coverage in excess of \$50,00 is includable in gross income with the cost being determined by utilizing the Table 1 rates published by the IRS.

12. COBRA premiums for an employer-sponsored group health plan are qualified benefits if:

- The premiums are excludable from an employee's income under IRC Section 106.
- The premiums are for the employee's employer-sponsored plan. This includes COBRA premiums any new employee may be paying for a former employer's health plan.
- COBRA premiums for a former spouse or non-dependent may be paid through the cafeteria plan with after-tax contributions.

13. Individually-owned policy premiums are a qualified benefit. Individual health insurance premiums may be paid through the cafeteria plan on a non-taxable basis. The policy itself must be maintained by the employee, and not by their spouse or dependents.

14. Insurance premiums for employer-funded health insurance plans are excludable from gross income. The self-funded insurance plan must reimburse only medical expenses and has to satisfy the 105(b) nondiscrimination rules.

15. Deferral of compensation not allowed through a cafeteria plan. This means that dollars set aside as pre-tax contributions in one cafeteria plan year may not be used in any subsequent plan years to buy benefits. There are a few exceptions to this rule:

- 401(k) plan contributions.
- Certain plans maintained by an educational organization.
- Contributions to a Health Savings Account (HSA).

Paid time off is permitted as a taxable benefit through the plan, but only if it does not operate to sanction the deferral of compensation. That is to say that any unused paid time off days that were purchased through the cafeteria plan that are not used by the end of the plan year must be cashed out or forfeited. There is an ordering rule to determine when elective paid time off days have been utilized.

The participant is considered to have used the days purchased through a cafeteria plan only after using all their non-elective (employer provided) paid time off. And, participants do not have the 2-½ month extended period of coverage after the end of a plan in which to use their purchased time off. All days must be used, forfeited or cashed out by the last day of the cafeteria plan year.

16. Eligible benefits that relate to more than one year. Some types of benefits may seem as if they are in direct conflict with the "no deferred compensation" rules. So the IRS gave us a list of the type of insurance features and/or riders that are not considered to defer compensation:

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- Credit toward the deductible for unreimbursed covered expenses incurred in prior periods.
- Reasonable lifetime maximum limit on benefits.
- Level premiums.
- Premium waiver during disability.
- Guaranteed renewability of coverage.
- Coverage for a specified accidental injury.
- Coverage for a specified disease or illness.
- Payment of a fixed amount per day of hospitalization.
- Benefits under a long-term disability policy relating to more than one year.
- Reasonable premium rebates or policy dividends if rebates or dividends are paid before the close of the 12-month period immediately following the cafeteria plan year.
- Mandatory two-year election for some vision or dental insurance plans is OK.
- Using salary reduction amounts from one plan year to pay premiums for the first month of the immediately following plan year. We call this a “straddle” premium payment.

No part of any benefit within an insurance policy may be paid for in one plan year to purchase a benefit in a subsequent plan year, the policy only stays in force if premiums are timely paid, there is no investment fund or cash value, and no part of any premium is held in a separate account for an individual that is separate from the assets of the insurance company.

17. Nonqualified benefits:

- Scholarships.
- Employer-provided meals and lodging.
- Educational assistance.
- Fringe benefits like parking and transportation plans.
- Long-term care insurance, unless purchased through an HSA.
- Long-term care services, unless paid for through an HSA.
- Group-term life insurance on the life of any individual other than an employee.
- Health Reimbursement Arrangements (HRAs).
- Employee contributions to an Archer Medical Savings Accounts (MSAs).
- Elective deferrals to a section 403(b) plan.

A plan that offers these nonqualified benefits is not a cafeteria plan. This would result in all benefits, qualified or not, offered through the plan to be taxable income to all participants.

18. Salary redirection in general. Employer contributions to a cafeteria plan are amounts that are not currently available to the employee but are specified in the cafeteria plan as amounts that an employee may use for the purpose of electing benefits through the plan.

A cafeteria plan may require employees to pay for the employee’s share of any qualified benefit with pre-tax dollars and reasonable administrative fees may be paid with employee salary redirections.

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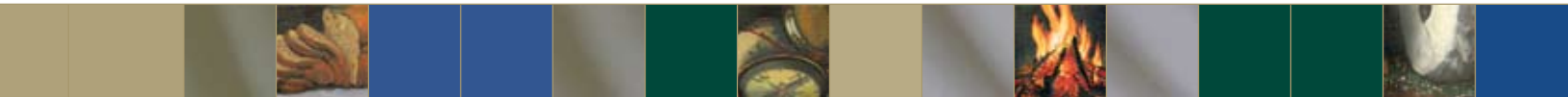
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As a reminder - the regulations are due to become effective on January 1, 2009. Plan documents must be amended or restated for mandatory changes before that time. However, some or all of the new regulations may be utilized now in the administration of a cafeteria plan. That means plan sponsors can immediately institute pieces of the new legislation that they like and then wait until the last minute to establish the changes that are complicated or difficult to administer.

Stay tuned as we will continue our journey through a new set of IRS regulations affecting cafeteria plan elections. To view previous article [click here](#). ■

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