



New Cafeteria Plan Regulations – 1.125-5

The fifth set of Internal Revenue Code (IRC) Section 125 regulations defines a flexible spending account (FSA), outlines rules on how FSAs are structured, summarizes Health Savings Account- (HSA) compatible health FSAs and describes a plan sponsor's options for the plan's experience gains.

1.125-5 – Definition of flexible spending accounts.

In general, an FSA is a benefit program that provides employees with coverage which reimburses specified, incurred expenses (subject to certain rules and conditions). Qualified FSA benefits include child/dependent care, adoption assistance, and medical reimbursement benefits.

Now let's dig into FSAs and find out what the Internal Revenue Service (IRS) has to say about establishing, managing and administering these types of benefits.

- 1. Period of coverage.** Expenses must be incurred during a participant's period of coverage. This means that the participant must have been enrolled and covered by the plan before eligible expenses are incurred. For instance, a participant could not enroll in the plan on June 1 and be reimbursed for expenses incurred prior to that date. The regulations also noted that claims submitted by participants must be substantiated before expenses are reimbursed. This requirement is discussed in more detail under the 1.125-6 Regulations.
- 2. Use-it-or-lose-it rule and uniform coverage.** There is nothing new here, and employees and employers have worked with these two rules since the beginning of cafeteria plans. But, just to bring you up to speed if you're new to the business, here is what this rule has to say. If a participant does not use all their contributions by the end of the plan or designated usage period, the funds left in their account will be forfeited to the plan. They may not receive these funds back as cash and they may not be used in the next plan year. However, plan forfeitures may be returned to participants in a uniform and nondiscriminatory basis. See number seven in this article for more information on forfeitures to the plan.

The uniform coverage rule applies to employers. This means that a participant's annual election is available for reimbursement at all times during the plan, regardless of how much the participant has contributed to date.

Here is an example of the uniform coverage rule. During the first month of a plan year a participant incurs an eligible medical expense that is equal to their annual election amount. Although they may have only contributed 1/12 of their annual election, the employer is obligated to reimburse eligible expenses up to the annual election amount, regardless of the contributions received to date.

Contributions may not be accelerated to cover this large expense, and any contributions that may have been collected in advance by the employer must be returned to a terminating employee.

Fortunately, the uniform coverage rule applies only to the health FSA and not to either the dependent care nor to the adoption assistance portions of the plan.

- 3. Twelve-month period of coverage required.** Generally, each cafeteria plan year must provide for a 12-month period coverage, except for allowable short plan years. The plan can have a separate, and different, period of coverage for each FSA benefit within the plan, but it's hard to see the applicability of this rule. It seems this practice would tend to be confusing for participants.

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Elections must be made for an entire plan year and coverage cannot be purchased on a month-by-month basis or just for periods when medical expenses will be incurred.

- 4. Limiting enrollment in the health FSA, collecting contributions and employer flex credits.** Plan sponsors may limit enrollment in the health FSA to only employees who participate in the employer's health plan and may specify any interval for collecting participant contributions.

Employer flex-credits may be made available to eligible employees. The IRS's definition of employer flex-credits includes non-elective employer contributions to be used by participants to purchase one or more qualified benefits.

- 5. General FSA rules.** Each benefit offered through the plan is a separate aspect of the plan and cannot be combined with other benefits. For example, a separate election must be made for each benefit and claims for one type of benefit cannot be reimbursed from another benefit.

Each benefit must satisfy all the IRC Section 125 rules plus their own code section rules. For the dependent care portion of the plan, that would be IRC Section 129, IRC Section 105 and 106 for the health FSA and IRC Section 137 for the adoption assistance benefit. In addition, health FSAs must comply with the nondiscrimination rules under 105(h) and with applicable COBRA requirements.

The health FSA must not reimburse premiums for accident and health insurance or for long-term care insurance or services. This would not preclude the plan from including a provision for the reimbursement of individually-owned health insurance policy premiums through a separate FSA benefit. And long-term care insurance or services may be reimbursed from an HSA that is part of a cafeteria plan.

The plan may limit the type of 213(d) eligible medical expenses paid from the health FSA. Through plan design, the sponsor may decide that the plan will not reimburse big-ticket items like LASIK surgery or hard to administer items like medical mileage or over-the-counter medications.

The prohibition of deferring compensation through a cafeteria plan does not include the purchase of durable medical equipment or advance orthodontia payments through the plan. Advance orthodontia payments must be a requirement by the dentist in order to receive the services.

- 6. HSA-compatible FSAs and qualified HSA distributions.** As mentioned in previous articles, this section is an instance where separate guidance was gathered, consolidated and codified within the new regulations. HSA-compatible health FSAs, or limited-purpose health accounts, were originally established in Revenue Ruling 2004-45. (Click here to read the August 2004 article in *Broker World* for a full discussion of this provision.)

Qualified HSA distribution rules were detailed in Notice 2007-22. (Click here to read the May 2007 article in *Broker World* for the rules surrounding distributions from a health FSA to an HSA.)

- 7. FSA experience gains.** At the conclusion of any cafeteria plan year, all participant accounts are generally not zero. Some terminated participants may have received more payments than they contributed. Current employees may not have used all the contributions they placed in the plan. So, at the end of the plan year, the plan either has a loss or an experience gain. When determining experience gains, or employee forfeitures, the end of the plan year includes the 2-1/2 month extended period of coverage and the run-out period.

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If the plan has dollars left over the money may, on a reasonable and uniform basis, be:

- Retained by the plan sponsor.
- Used by the employer to defray administrative expenses.
- Used to reduce the required employee salary reduction amounts for the immediately following plan year.
- Used to reimburse claims incurred above the participant's annual election amount.
- Returned to the employees as taxable income.

Experience gains returned or allocated to participants may not be based directly or indirectly on the individual participant's claim experience. In other words, money cannot be returned to just the employees who lost money to the plan. If one participant forfeited \$500 and another forfeited \$1,000, their individual losses could not be returned to them. Dollar amounts returned or allocated to participants may be divided equally among participants, or allocated based on:

- Different annual elections selected by each employee.
- Claims incurred above the annual election amount.

What should a plan sponsor do?

Remember – a lot of this information is not new. Cafeteria plans have run under these same rules for years. The IRS has just put it all in one spot. So although the new regulations may seem tedious, it puts everything in one place that is readily accessible to everyone.

Plan sponsors need to understand the new regulations in regard to their own cafeteria plan. This might take the form of studying the regulations or consulting with a trusted plan service provider or ERISA attorney. Some of the regulations must be incorporated into plan documents, while others are optional.

As of right now, 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. ■

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