



New Cafeteria Plan Regulations – 1.125-6

The sixth set of Internal Revenue Service (IRS) Regulations focus on cafeteria plan payments and reimbursements. In addition, the regulations point out that a plan can only pay for qualified expenses, what constitutes substantiation and debit card rules for payments from the plan.

Nothing much new in this set of regulations. In fact, a great deal of the information has already been set forth in the second set of proposed regulations that were issued in 1989. The rest of this particular regulation comes from previous IRS publications. For instance, the use of a debit card by participants was detailed in earlier Revenue Rulings and a Notice.

1.125-6 – Rules on substantiation of all expenses paid from a cafeteria plan.

A cafeteria plan may only pay or reimburse expenses that are substantiated expenses for qualified benefits. That's as simple as it gets. This regulation also defines how claims are to be substantiated and walks the reader through determining whether a claim is eligible or ineligible.

- 1. Claims must be incurred during a participant's "period of coverage."** A claim submitted for reimbursement or paid with the use of a debit card must be for expenses incurred on or after the later of the effective date of the plan or the date the employee is enrolled in the plan. This is called the start of a participant's period of coverage. Their entire period of coverage spans the time after they become participants in the plan, while they are making contributions for coverage and before the end of the plan year or their coverage period; whichever comes first.

This period of coverage includes the 2-½ month extended period of coverage after a plan year ends that may be afforded by the employer or COBRA continuation coverage. However, the actual reimbursement may occur after a participant's period of coverage has ended. The plan document will clarify when and in what manner disbursements will occur through the plan.

- 2. When is an expense incurred?** An eligible expense must be incurred before payment may be made from the plan. Expenses are incurred at the time the participant or the participant's spouse or dependent is provided with medical care. Not when the employee is formally billed, charged for or pays for the medical care. Therefore, advance reimbursement of expenses not yet incurred is not allowed. Neither is an arrangement whereby the employer makes a "loan" to a participant based on actual or projected employee claims.
- 3. What medical expenses may be paid from a cafeteria plan?** Some people think that the IRS has a long list of eligible and ineligible expenses. This is not true – no such list exists. Instead, the IRS provides us with a definition of an eligible medical expense. That definition states: Amounts paid for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body. This definition includes transportation for and essential to medical care and legally obtained drugs or biologicals that require a prescription. For reimbursement from a cafeteria plan, this also encompasses certain over-the-counter drugs or medicine.
- 4. What dependent care expenses may be paid from a cafeteria plan?** Eligible dependent care expenses include expenses paid for the care of a dependent child or adult so that the participant may work or look for work. The dependent must reside with the participant for at least eight hours per day and be under the age of 13, a parent or a disabled adult or child.

Again, the claims must be incurred during a participant's period of coverage. However, the IRS has provided an optional "spend-down" provision.

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The IRS has said it is OK for a terminated participant in the dependent care portion of the plan to continue to incur expenses and be reimbursed from the plan after their termination date. So, any unused contributions may be spent by the terminated employee during the remainder of the plan year for expenses incurred after they leave employment.

Nevertheless, contributions for the dependent care portion of the plan that remain unused after the end of the plan year would be forfeited to the plan. In fact, the plan may not return cash to participants – from any benefit within the cafeteria plan – who have not used all their contributions by the end of the plan year.

Arrangements outside of the cafeteria plan that adjust compensation or other benefits on the basis of expenses incurred or contributions forfeited to the plan will endanger the non-taxable status of the entire plan.

- 5. Substantiation by an independent third party.** All expenses paid from the plan must be substantiated by information received from an independent third party. In most cases, this means a detailed receipt showing the date of service or sale, the amount and a description of the service or product.

Self substantiation by an employee does not satisfy the substantiation requirements. In other words, a participant cannot attach a note to their claim form that basically attests to the fact that they incurred an eligible expense during their period of coverage. The substantiation must be verified from the vendor or service provider.

An explanation of benefits (EOB) provided by an insurance company would qualify as third-party substantiation for this rule. The EOB information must be sent from an insurance carrier and contain the date of the service and the amount of the employee's responsibility for the service. The employee must also certify that any expenses paid through the health FSA have not been reimbursed and that the employee will not seek reimbursement from any other plan.

- 6. Debit cards used for payment of plan expenses.** The IRS has issued previous guidance on the requirements for the use of debit cards to pay eligible benefit expenses. Revenue Ruling 2003-43, Notice 2006-69 and Notice 2007-2 inaugurated these principles. Click to read the [August 2003](#), [October 2006](#), and [March 2007](#) articles in *Broker World* for all the directives surrounding the use of debit cards.

It should be noted that when it comes to the Inventory Information Approval System (IIAS) discussed in these Revenue Rulings and Notice, that the employer is responsible for ensuring IIAS compliance. What does this mean? Employers must know that their third party administrators have completed their due diligence on all the debit card vendor processes.

When will the new regulations become final?

The IRS has indicated that the final regulations should be published by June 2008 in order for them to be effective on January 1, 2009. At this time, it looks like they may be finalized later in the summer or early fall. If that is the case, their effective date will be extended for plan years beginning on or after January 1, 2010.

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.

The next Flex Flash will be the closing article in this series and will chronicle the final set of proposed IRS regulations 1.125-7. The subject is nondiscrimination rules for cafeteria plans. ■

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