



New Cafeteria Plan Regulations... Lessons from the Past

If asked to chronicle the last 20 years of your life, what steps do you think you would need to take? Gather old documents from your past, remember what you had said and done and then update the reality? After all, no one wants to admit to earlier mistakes. Well, that is exactly what the Internal Revenue Service (IRS) has accomplished with the issuance of new cafeteria plan regulations.

These proposed regulations, issued in August 2007, contain some things old and new, plus some things borrowed or askew. Where previously gray, areas have now turned black and white, a whole new crop of ambiguous grays are there to take their place.

The new regulations withdraw the old, proposed regulations and notices that were published in 1984, 1989, 1997, and 2000, and replace them with regulations numbered 1.125-1, 1.125-2, 1.125-5, 1.125-6, and 1.125-7.

So what happened to 1.125-3 and 1.125-4? Those final regulations concerning cafeteria plans still stand and will not be affected by the new rules. The 1.125-3 regulations outline how the Family and Medical Leave Act (FMLA) impacts cafeteria plan elections, while the 1.125-4 regulations summarize when a cafeteria plan may permit election changes during a plan year.

What are the biggest changes?

- The IRS begins to use phrases like premium only plan, employer flex credits, short plan year, and paid time off.
- COBRA continuation for coverage that is sponsored by a spouse's or dependent's employer may be paid through a cafeteria plan.
- Individually-owned insurance policy premiums may be paid through a cafeteria plan.
- Automatic enrollment and notice requirement established.
- IRS Table 1 rates are used to determine taxable income where coverage exceeds \$50,000 of group-term life insurance.
- Premiums that are payroll deducted in one plan year may be used for coverage in the subsequent month that may be the start of a new plan year.
- Administrative fees may be paid by participants with pre-tax dollars.
- Elections are not required to be in writing.
- Optional election for new employees gives them 30 days after their date of hire in which to make elections that are effective as of their hire date.
- Health Flexible Spending Account (FSA) enrollment may be limited to employees who participate in the employer's health plan.
- Detailed nondiscrimination tests and how to operationally conduct the tests.
- Safe harbor for premium only plans where only one nondiscrimination test must be passed.
- New definitions for Highly Compensated and Key Employees.

As you can see, this is a mammoth laundry list – and it's just the big stuff. This Flex Flash will encapsulate the contents of each new regulation, with detailed issues to follow in the upcoming months for:

1.125-1 – Rules on qualified and nonqualified benefits in a cafeteria plan

Clarifies and amplifies the general management of a cafeteria plan. It contains written plan document requirements, along with a discussion of grace period, run-out period, and after-tax employee contributions. It also includes communication on prohibited taxable benefits,

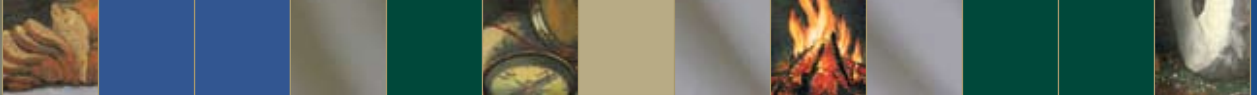
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COBRA premiums, prevention of deferred compensation, nonqualified benefits and employer contributions to a cafeteria plan.

These new regulations have “teeth.” It was not enough to expound on the rules surrounding cafeteria plans, the IRS now says, “if you don’t follow these rules, you do not have a cafeteria plan.” That means that what participants thought was a non-taxable benefit is now taxable to them and their employers. Plus penalties and interest on the overdue taxes may apply.

1.125-2 Elections

When and how elections are made to a cafeteria plan, the irrevocability of elections and automatic elections. Election rules for contributions to a Health Savings Account (HSA) and the newest 30-day optional election period for new employees are maintained in this regulation.

1.125-5 Flexible spending arrangements

Some old and some new rules here. The IRS has retained the use-it-or-lose-it rule plus uniform coverage for the Health FSA. A list of qualified benefits, specific rules for Health FSAs, dependent care assistance programs, and adoption programs are outlined in addition to rules for HSA-compatible flex accounts. HSA distributions from a health FSA and experience gain rules are incorporated in the -5 regulations.

1.125-6 Substantiation of expenses

Cafeteria plan payment and reimbursement rules that encompass an overview on flex benefit card usage, substantiation rules, Inventory Information Approval System (IIAS) statutes and how flex benefit cards are used to pay for dependent care expenses. Also included are detailed examples of when a dependent care expense is incurred, when that expense can be reimbursed from the plan and an optional spend-down provision for terminated participants.

1.125-7 Nondiscrimination rules

Suffice to say “there’s a new sheriff in town” and the new rules and regulations surrounding discrimination testing are spelled out clearer and are more complicated. The good news? An automatic pass for premium only plans that smaller employers will be able to utilize and a new definition of highly compensated employees.

How do proposed regulations become final?

1. Published August 2007
2. Comments welcomed by the IRS by November 5, 2007 with a hearing on November 15, 2007
3. Updated proposed regulations reissued
4. Final regulations made public in the summer of 2008
5. Regulations effective for plan years starting in 2009

What should plan sponsors do?

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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