

# Client Alert

A report  
for clients  
and friends  
of the Firm      September 2007

## IRS Issues New Proposed Regulations on Cafeteria Plans

On August 6, 2007, the Internal Revenue Service (the “IRS”) issued new proposed regulations regarding cafeteria plans under Section 125 of the Internal Revenue Code of 1986, as amended (the “Code”). Cafeteria plans are the sole method through which an employer may offer employees a choice between taxable and nontaxable benefits without the choice itself resulting in includible income for the employees. In order to provide such benefits, a cafeteria plan must comply with all of the requirements of Code Section 125 and IRS regulations. The options available under a cafeteria plan must include cash (or certain taxable benefits treated as cash for this purpose) and at least one “qualified benefit.” If the plan only offers qualified benefits or only offers taxable benefits, it is not a cafeteria plan and is not subject to Section 125 regulations.

The proposed regulations are the most comprehensive regulations published under Code Section 125 to date, and incorporate various previously issued guidance and reflect the relevant recent changes to the tax law.

*The proposed regulations are generally effective for plan years beginning on and after January 1, 2009, but may be relied on in the interim. In connection with the issuance of the proposed regulations, the IRS has withdrawn prior proposed and temporary regulations under Code Section 125.*

### Proposed Regulations

The proposed regulations are organized into five sections: (i) general rules on qualified and nonqualified benefits in cafeteria plans; (ii) general rules on elections, (iii) general rules on flexible spending arrangements (“FSAs”); (iv)

general rules on substantiation of expenses for qualified benefits; and (v) nondiscrimination rules.

Many of the topics addressed in the withdrawn proposed regulations have been incorporated into the proposed regulations and, in certain cases, clarified, but remain substantially unchanged, including:

- the basic framework and requirements for cafeteria plans and elections under cafeteria plans;
- the significant rules for benefits under a health FSA offered by a cafeteria plan, including that (i) the maximum reimbursement available under a health FSA be available at all times during the coverage period, (ii) the coverage period be a 12-month period, (iii) the health FSA only reimburse qualifying medical expenses (which include dental and vision expenses), (iv) all medical expenses be substantiated by a third party before reimbursement, (v) expenses be incurred during the period of coverage, (vi) the “use or lose” rule governs and (vii) the deferral of compensation is prohibited;
- guidelines for dependent care flexible spending arrangements; and
- the application of Code Section 125 to paid vacation days offered under a cafeteria plan.

### Recent Changes in Tax Law Reflected

The proposed regulations reflect recent changes in tax law, including the change in the definition of “dependent” under Section 152 of the Code, and the addition of the following benefits as qualified benefits under a cafeteria plan: (i) adoption assistance; (ii) additional deferred compensation benefits; (iii) Health Savings Accounts (HSAs); and (iv) qualified distributions from health FSAs to HSAs.

## Key Provisions in the Proposed Regulations

**Exclusive Noninclusion Rule.** The proposed regulations clarify and amplify the general rule that a Section 125 plan is the exclusive means by which an employer may offer employees a choice between a taxable and nontaxable benefit without the choice itself resulting in its inclusion in his or her gross income.

**Writing and Content Requirements.** The proposed regulations include a written plan requirement for all cafeteria plans, and specify what information must be set forth in the document, including a specific description of all benefits, the eligibility rules and election procedures, that only employees (including former employees so long as they are not the predominant motivation for the plan's establishment) may participate (in the case of former employees, on an after-tax basis only (note: benefits may be paid from severance on a pre-tax basis)), that elections are irrevocable (except in accordance with the optional change in status rules and in the case of HSA elections), how employer contributions will be made under the plan, the maximum amount of elective contributions and the plan year.

If the cafeteria plan includes an FSA, the plan must provide that any unused portion of the FSA remaining at the end of the plan year or applicable grace period will be forfeited. This requirement is commonly referred to as the "use or lose" rule. Health FSAs must provide that the maximum amount of reimbursement elected by a participant (reduced to reflect any prior reimbursements) will be available at all times during the period of coverage, regardless of the amount actually contributed by the participant. This requirement is known as "uniform coverage."

**Qualified and Non-Qualified Benefits.** The qualified benefits approved for coverage under a cafeteria plan include employer-provided accident and health plans, accidental death and dismemberment policies, FSAs, group-term life insurance (to a maximum of \$50,000), long and short-term disability coverage and the following newly added benefits: adoption assistance programs and contributions to HSAs. The proposed regulations also clarify that while long-term care services are nonqualified benefits, to the extent an HSA is funded through a cafeteria plan it may be used to pay for long-term care premiums.

**Group Term Life Insurance & Includible Income.** Under the proposed regulations, the cost of group term life insurance in excess of \$50,000 is includible in income only as to the cost of the excess coverage (minus any after-tax contributions made by the employee for the coverage), and the entire amount of salary reductions and/or employer flex-credits used for the group-term life insurance coverage is excludible. This method of calculating includible income is different from the method required under prior guidance, and became effective as of the date the proposed regulations were published in the Federal Register.

**Grace Periods and Run-Out Periods.** The proposed regulations provide additional guidance concerning grace periods. An employer is permitted, but not required to provide a grace period under an FSA, which allows participants to be reimbursed for expenses for certain qualified benefits incurred on or prior to the fifteenth day of the third month following the end of the plan year (subject to the participant having a sufficient account balance).

A cafeteria plan may also provide for a period after the end of the plan year or grace period during which a participant may submit a claim for reimbursement for a qualified expense incurred during the applicable plan year or grace period. This is known as a "run out period." The proposed regulations clarify that the run-out period may begin at the conclusion of the grace period, an issue which had not been addressed in prior guidance.

**After-Tax Employee Contributions.** Under the proposed regulations, if a qualified benefit is purchased by an employee under the cafeteria plan with after-tax contributions, the benefit is a permitted taxable benefit and will be treated as cash for purposes of Code Section 125.

**New Employees.** Under the proposed regulations, a plan may allow new employees to elect coverage under the cafeteria plan within 30 days of their hire date, with coverage under the plan to be retroactive to the employee's date of hire. Notwithstanding this rule, the salary reductions may only be made on a prospective basis. The proposed regulations also require that any employee who is rehired within 30 days of termination or returns to employment within 30 days of starting an unpaid leave of absence will not be eligible for such an election.

**Paid Time Off.** The proposed regulations provide that elective paid time off (i.e., vacation days, sick days or personal days) is permitted as a taxable benefit offered through a cafeteria plan, but only if the deferral of income is not permitted. To avoid any such deferral, a cafeteria must require that an employee receive cash for, use or forfeit paid time off before the last day of the cafeteria plan year to which the elective contributions relate.

**Making, Changing & Revoking Elections.** The proposed regulations require that all elections made under a cafeteria plan (other than HSA elections) must be made annually and be irrevocable, subject to the permitted changes for certain changes in status. If HSA contributions are made through a cafeteria plan, the plan must provide that employees may elect, revoke or change salary reductions (with respect to the HSA only) on a prospective basis at any time (and at least monthly) during the plan year.

**Health Savings Accounts.** The proposed regulations include guidance on funding an HSA through salary reductions under a cafeteria plan, incorporate the rules on qualified distributions from Health FSAs to HSAs and clarify that employer contributions to an HSA through a cafeteria plan are subject to

Code Section 125 nondiscrimination rules and not the comparability rules in Code Section 4980G. To offer an HSA as a qualified benefit, the plan must specifically describe the HSA benefit, allow prospective elective changes, and allow prospective revocations in the case of employees who become ineligible for HSA contributions.

**FSA Forfeitures.** Under the proposed regulations, the amount remaining in an FSA after all reimbursements have been made, may be (i) retained by the employer, (ii) used to defray the plan's administration expenses, or (iii) used to reduce salary reductions for the forthcoming plan year or returned to employees on a reasonable and uniform basis.

**Dependent Care Spend-Down.** Under the proposed regulations, employers may permit terminated employees to continue to be reimbursed for dependent care expenses incurred after termination and prior to the end of the applicable plan year or applicable grace period to the extent there are any unused benefits in the employee's dependent care FSA.

**Debit Cards, Substantiation and Record Keeping.** The proposed regulations incorporate previously issued guidance regarding the reimbursement of medical and dependent care expenses incurred using debit cards. The proposed regulations also require that a cafeteria plan may only reimburse qualified expenses that are substantiated by a third party, and specify recordkeeping requirements.

**Nondiscrimination Rules.** Cafeteria plans are subject to certain nondiscrimination rules that prohibit the discriminatory provision of benefits to highly compensated participants and key employees. Under the proposed regulations, a cafeteria plan must not discriminate in favor of highly compensated participants as to employer contributions or the availability of benefits under the plan. As a result, a plan must give similarly situated participants a uniform opportunity to elect qualified benefits and the actual election of such benefits must not be done disproportionately by highly compensated participants.

The proposed regulations on nondiscrimination testing have been updated to reflect changes in the law since the 1984 proposed regulations, including statutory nontaxable benefits, the key employee concentration test regarding the percentage of the aggregate statutory nontaxable benefits that are provided to key employees, and the change in the definition of dependent. In addition, the proposed regulations define several key terms, and provide additional guidance on the eligibility, contribution and benefits tests, excludable employees for testing purposes, and a safe harbor nondiscrimination test for premium-only plans.

## Full Text

The full text of the proposed regulations is available at:  
<http://www.ustreas.gov/press/releases/reports/section125.pdf>

## Comment Period

The IRS will accept comments on the proposed regulations until November 5, 2007.

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### Client Alert

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