

Newsletter

New Proposed Regulations on Cafeteria Plans

By Jeremy M. Pelphrey

In August, 2007 the Internal Revenue Service issued new proposed regulations governing the operation of cafeteria plans under Section 125 of the Internal Revenue Code of 1986, as amended ("Code"). The new proposed regulations are effective for plans years beginning on or after January 1, 2009. These regulations replace and incorporate previously issued regulations and guidance and expand on issues not addressed previously.

Section 125 of the Code is the exclusive means by which an employer may offer employees a choice between taxable and nontaxable qualified benefits without that choice resulting in taxable income to the employees.

Employers should review the new proposed regulations with legal counsel and third-party administrators to identify changes that need to be made to cafeteria plan documentation and administrative practices. The failure to operate a cafeteria plan in accordance with the new proposed regulations, the Code and the terms of its plan document will result in the disqualification of the entire plan and employees will be deemed to have received taxable income. Furthermore, the disqualification of a cafeteria plan will result in additional tax liability to the employer.

Section 125 of the Code provides that, except in the case of certain discriminatory benefits, no amount shall be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan.

When employees may elect between taxable and nontaxable benefits, this election results in gross income to employees, unless a specific Internal Revenue Code (such as Section 125) intervenes to prevent gross income inclusion.

A participant in a nondiscriminatory cafeteria plan will not be treated as having received a taxable benefit offered under the plan solely because the participant

has the opportunity, before the benefit becomes available, to choose among the taxable and nontaxable benefits under the plan.

Definition of a Cafeteria Plan

The new proposed regulations provide that a cafeteria plan is a separate written plan that complies with the requirements of Section 125 of the Code, that is maintained by an employer for employees and that is operated in compliance with the requirements of Section 125 and the regulations thereunder.

The new proposed regulations expand on the information that is required of a plan document. Unchanged is that a plan must be adopted and effective on or before the first day of the plan year to which it relates and must apply uniformly to all participants. Retroactive adoption and amendments are prohibited.

Written Plan

Section 125(d)(1) of the Code requires that a cafeteria plan be in writing. The written plan document must contain (1) a specific description of each benefit available; (2) rules governing participation and eligibility; (3) procedures governing elections; (4) the manner in which employer contributions may be made under the plan; (5) the maximum amount of salary reduction available; (6) the plan year; (7) if paid time off is permitted, the required ordering rules; (8) a description of the grace period for incurring expenses under an FSA or dependant care; and (9) if there is an FSA, the required "use or lose" rule.

Individuals Who May Participate in a Cafeteria Plan

All participants in a cafeteria plan must be employees. The new proposed regulations provide that employees include common law employees, leased employees described in Section 414(n) of the Code, and full-time life insurance salesmen. The new proposed regulations further provide that former employees (including laid-off employees and retired

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employees) may participate in a plan, but a plan may not be maintained predominately for former employees.

Election Between Taxable and Nontaxable Benefits

The new proposed regulations require that a cafeteria plan offer employees an election among only permitted taxable benefits (including cash) and qualified nontaxable benefits. Distribution from qualified retirement plans are not cash or taxable benefits for purposes of Section 125.

Qualified Benefits

In general, in order for a benefit to be a qualified benefit for purposes of Section 125, the benefit must be excludible from employees' gross income under a specific provision of the Code and must not defer compensation, except as specifically allowed in Section 125(d)(2)(B), (C) or (D). Examples of qualified benefits include the following: group-term life insurance on the life of an employee; employer-provided accident and health plans, including health flexible spending arrangements, and accidental death and dismemberment policies; a dependent care assistance program; an adoption assistance program; contributions to a section 401(k) plan; contributions to certain plans maintained by educational organizations, and contributions to HSAs. A cafeteria plan may also offer long-term and short-term disability coverage as a qualified benefit.

Employer Contributions Through Salary Reduction

Employees electing a qualified benefit through salary reduction are electing to forego salary and instead to receive a benefit which is excludible from gross income because it is provided by employer contributions. Section 125 provides that the employee is treated as receiving the qualified benefit from the employer in lieu of the taxable benefit. A cafeteria plan may impose reasonable fees to administer the cafeteria plan which may be paid through salary reduction.

No Deferral of Compensation

Qualified benefits must be current benefits. In general, a cafeteria plan may not offer benefits that defer compensation or operate to defer compensation. Benefits may not be carried over to a later plan year or used in one plan year to purchase benefits to be provided in a later plan year. For example, life insurance with a cash value build-up or group-term life insurance with a permanent benefit defers the receipt of compensation and thus is not a qualified benefit.

Making, Revoking and Changing Elections

Generally, a cafeteria plan must require employees to elect annually between taxable benefits and qualified benefits. Elections must be made before the earlier of the first day of the period of coverage or when benefits are first currently available. Annual elections generally must be irrevocable and may not be changed during the plan year.

A cafeteria plan is permitted to include an automatic election for new employees or current employees. New employees avoid gross income inclusion if they make an election within 30 days after the date of hire even if benefits provided pursuant to the election relate back to the date of hire.

Grace Period

Unused benefits or contributions for one qualified benefit may only be used to reimburse expenses incurred during the grace period for that same qualified benefit. The amount of unused benefits and contributions available during the grace period may be limited by the employer. A grace period may extend to the fifteenth day of the third month after the end of the plan year (but may be for a shorter period). Benefits or contributions not used as of the end of the grace period are forfeited under the "use-or-lose" rule. The grace period applies to all employees who are participants (including through COBRA), as of the last day of the plan year.

Nonqualified Benefits

A cafeteria plan must not offer any of the following benefits: scholarships; employer-provided meals and lodging; educational assistance; fringe benefits; long-term care insurance. (An HSA funded through a cafeteria plan may, however, be used to pay premiums for long-term care insurance or for long-term care services.) The new proposed regulations clarify that contributions to Archer Medical Savings Accounts, group term life insurance for an employee's spouse, child or dependent, and elective deferrals to section 403(b) plans are also nonqualified benefits.

Incurring and Reimbursing Expenses for Qualified Benefits

The new proposed regulations provide that only expenses for qualified benefits incurred after the later of the effective date or the adoption date of the cafeteria plan are permitted to be reimbursed under the cafeteria plan. Similarly, if a plan amendment adds a new qualified benefit, only expenses incurred after the later of the effective date or the adoption date are eligible for reimbursement.

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Substantiation

The new proposed regulations provide rules regarding the substantiation of expenses under a cafeteria plan. All reimbursements must be substantiated by a third party, independent of the employee.

Nondiscrimination Requirements

The new proposed regulations provide additional guidance on the cafeteria plan nondiscrimination rules, including definitions of key terms, guidance on the eligibility test and the contributions and benefits tests, descriptions of employees allowed to be excluded from testing and a safe harbor nondiscrimination test for premium-only-plans.

Cafeteria plans must not discriminate in favor of highly compensated individuals with respect to eligibility, contributions and benefits. The plan must be tested annually as of the last day of the plan year to determine discrimination. If the plan is discriminatory, the highly compensated participants must include in income an amount equal to the highest value of benefits that could have been elected under the plan.

Unlike other qualified plans under the Code, highly compensated individuals are those who in the current plan year are (i) an officer, (ii) a more than 5% shareholder of the employer, (iii) highly compensated, or (iv) a spouse or dependent of one of the foregoing. A somewhat broad departure in definitions of highly compensated individuals is that under the new proposed regulations, individuals can be included as highly compensated in their first year of employment.

Furthermore, each similarly situated employee must have the same opportunity to elect qualified benefits and those benefits must not be disproportionately elected or used by highly compensated individuals. The new proposed regulations contain an objective test for determining whether the actual election is discriminatory the aggregate qualified benefits elected by highly compensated individuals, calculated as a percentage of compensation, cannot exceed the aggregate qualified benefits elected by non-highly compensated individuals, calculated as a percentage. The new proposed regulations now add a new safe harbor for the nondiscriminatory benefits requirements if the plan is nondiscriminatory as to eligibility.

The changes under the new proposed regulations for cafeteria plans are not extensive, however, legal counsel and third-party administrators should be consulted to determine an employer's compliance.

Jeremy M. Pelphrey
Firm Associate 2004-2008

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For further information, please contact:

William H. Campbell
309.673.1681
whcampbell@dcamplaw.com

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