



## The Vita Viewpoint Important Information for Decision Makers

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### IRS Releases New Cafeteria Plan Regulations A Few Changes . . . Many Clarifications

#### Overview

On August 6, 2007, the IRS released the long-awaited proposed final regulations for cafeteria plans. These proposed final regulations replace existing regulations dating back to 1984. In general, these regulations preserve and finalize the existing rules outlined in the prior final regulations. In addition, the regulations provide clarification relating to both statutory changes and administrative guidance provided since the previous regulations were published. The new regulations also address many issues on which the IRS has previously provided informal, non-binding guidance.

#### Highlights

- Sole Method of Nontaxable Benefits. The proposed final regulations clarify that cafeteria plans are generally the sole method of preserving the nontaxable nature of employer-provided benefits where employees are allowed to elect between taxable compensation and a qualified nontaxable benefit.
- Discrimination Testing. New rules are provided to determine whether a cafeteria plan improperly discriminates in favor of highly compensated employees, including definitions of important terms. Previously, definitions of highly compensated employees, key employees, and officers were borrowed from pension rules. Now, cafeteria plans have their "own" definitions for each of these terms which essentially formalize the "borrowing" by mirroring those definitions. The new rules are generally consistent with the rules for qualified retirement plans. Also, the rules provide an objective test to determine if the actual election of benefits is discriminatory.
- Run Out Period Claims. The new regulations formalize previously issued informal guidance relating to the use of debit cards and grace periods for health and dependent care FSA monies after the end of a plan year.
- Key Provisions Retained. The general rules in the prior regulations for health FSAs are retained, including a 12-month plan year, requirements that the full reimbursement be available at any time during the plan year, restrictions on changing elections during the plan year, and the requirement that unused amounts at plan year end are forfeited (the "use-it-or-lose-it" rule).
- Dependent Care Reimbursement Timing. The regulations state that all dependent care must be incurred before amounts are reimbursed. A plan is no longer allowed to reimburse dependent care expenses in advance. *This is an important change that will directly affect (delay) the reimbursement timing of many plan participants.*
- Date of Hire Retro Election. Employers with date of hire eligibility may now allow for an election that is retroactive back to the date of hire so long as the election is made within 30 days of the date of hire. This new liberalization does not apply to plans with waiting periods other than date of hire.

- The IRS Means Business! The regulations clearly define “Operational Failures” of an IRC § 125 plan and clarify that any operational failure results in all non-taxable benefits received by all plan participants would become taxable. This portion extends not only to health FSA & DCAP monies but any amounts paid on a pre-tax basis for participation in a group health plan (i.e., employee contributions). This clearly illustrates the IRS intent to establish clear expectations regarding compliance and to impose significant adverse consequences for operational failures.
- Operational Failures Defined. Operational failures are defined to include offering non-qualified benefits, failing to comply with the use-it-or-lose-it rule, allowing employees to make election changes (except when expressly permitted), failing to satisfy appropriate claim substantiation requirements, and reimbursing expenses outside of the eligibility period (before hire date or after termination date).
- COBRA Premiums. COBRA premiums may be paid on a salary reduction basis. Despite this clarification, we would suggest exercising extreme caution in regards to making salary reductions other than under the employer’s OWN group health plan. Serious questions still exist regarding how an employer can satisfy its own COBRA requirements for providing 18 months of continuation coverage when an employee terminates and has elected to continue COBRA coverage under a former employer’s plan and has partially used up their 18 months of continuation coverage under that former employer’s plan.
- Individual Health Insurance Premiums. The regulations clarify that cafeteria plans may now permit payment or reimbursement of individual health insurance premiums under a plan. Reimbursement would be restricted to coverage in the name of the employee (and any dependents) but would not allow for reimbursement of coverage directly in the name of a family member other than the employee. Despite this new guidance, we suggest exercising caution when allowing reimbursement for individual health plans. There are currently unresolved HIPAA issues and potential COBRA concerns. Please also note that individual premiums (including COBRA) are not eligible for reimbursement under a health FSA.
- Debit Card Substantiation. New regulations incorporate previously issued guidance on substantiation requirements for debit card transactions. Debit cards may only be used for merchants with medical care merchant codes or merchants who have implemented an IIAS (Inventory Information Approval System) such as a SKU-level point-of-sale adjudication of eligible expenses. The regulations also state that a plan sponsor is required to employ all methods of “pay and chase” including card de-activation and recovery of funds for ineligible or non-documented expenses.
- Deferred Compensation Clarification. The regulations clarify that premium payments made on a pre-tax basis in the last month of the plan year can be used to pay for coverage in the first month of the following plan year.
- Safe Harbor Test for Premium-Only-Plans. A premium-only-plan is deemed to satisfy the nondiscrimination rules imposed under IRC § 125 for the plan year if the plan satisfies the safe harbor percentage test for eligibility. If the eligibility test is satisfied, the plan does not have to pass the contributions and benefits test as well as the 25% key employee concentration test. This addition to the regulations is welcome, especially for small employers.

***For questions or additional information, please contact Vita Benefits Group at (650) 968-8811.***