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August 21, 2007

**Re: New Cafeteria Plan Regulations**

Dear Clients and Other Friends:

On August 6, 2007, the IRS issued new proposed regulations on cafeteria plans maintained under Internal Revenue Code §125. These new proposed regulations, which can be relied on now, are expected to become final as of January 1, 2009.<sup>1</sup> These plans have not generally been closely scrutinized by the IRS up to now, but the IRS has informally indicated that it may begin to conduct audits of cafeteria plans once the new regulations become final, so it is worth employers' efforts to make sure their plans are compliant.

The proposed regulations consolidate and update the patchwork of proposed regulations, rulings and notices the IRS has issued over the last 23 years. The previously issued final regulations covering midyear election changes and coordination with the Family and Medical Leave Act remain the same.

This letter is a short summary of the key provisions of this new guidance that will be most important to employers. If you have a specific question about your plan, please contact us.

**A. General Requirements**

1. **Choice:** The plan must offer the employee a choice between at least one permitted taxable benefit (e.g., cash) and at least one qualified benefit (i.e., benefits that are nontaxable under some other section of the tax code). A plan that does not offer the employee a choice, or a plan that offers choices between taxable benefits only or between nontaxable benefits only, is not a cafeteria plan.

2. **Written Plan Document:** A cafeteria plan must be memorialized in a written plan document that contains several required provisions, including a description of the benefits offered, the rules governing participation, the procedures governing employees' elections, the maximum amount of employee and employer contributions, and the plan year. In addition, depending on the particular benefits offered, the plan document must include certain provisions

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<sup>1</sup> The one exception is the new rule for determining the taxable portion of group term life insurance coverage in excess of \$50,000 (see discussion on pages 2-3), which is effective immediately.

listed in the proposed regulations. For example, if the plan offers paid time off, the document must contain the required ordering rule for use of nonelective and elective paid time off. The document must be adopted and effective before the first day the plan is operated. The document may incorporate other documents by reference. The terms of the plan document must apply to all participants uniformly.

The plan may be amended, but amendments are not effective until after they are actually adopted.

3. **Employees:** In general, only employees may participate in a cafeteria plan. Former employees, retired or laid-off employees, may also participate but the plan may not be maintained primarily for them. If former employees are allowed to participate, the plan document must specify what types of benefits they may receive.

4. **Plan Year:** The cafeteria plan's plan year must be twelve (12) months. A short plan year is only allowed for a valid business reason.

5. **Included Benefits:** Qualified benefits include health insurance, accidental death and dismemberment coverage, dependent care benefits, long-term and short-term disability coverage, adoption assistance benefits, Health Savings Account (HSA) contributions, 401(k) contributions, and up to \$50,000 of group term life insurance on the employee. (Group term life insurance above \$50,000 may also be offered, but will be taxable to the employee).

Benefits that are not qualified and cannot be offered under a cafeteria plan include scholarships, educational assistance, long-term care insurance<sup>2</sup>, contributions to an Archer Medical Savings Account, dependent group term life insurance, and contributions to a Section 403(b) plan.

The regulations specifically provide that an employee may pay for an individual health insurance policy premium or a COBRA premium through a cafeteria plan on a pre-tax basis (but NOT through a health flexible spending account). If you choose to offer payment of health insurance or COBRA premiums through your cafeteria plan, you should be aware that such benefits may be subject to ERISA. Before you include these benefits in your cafeteria plan, be sure to consult your attorney.

## **B. Group Term Life Insurance**

It is worth emphasizing that only life insurance on the life of the employee may be paid for through a cafeteria plan. Life insurance premiums for life insurance on a spouse or dependents cannot be paid for through a cafeteria plan, whether on a pre-tax or after-tax basis.

The regulations also make a small change in how employer-provided group term life insurance over \$50,000 on the life of the employee is taxed. Generally, such coverage is taxable

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<sup>2</sup> Long term care insurance premiums and/or long term care costs may be paid out of an HSA that is funded through a cafeteria plan.

at rates (“Table I rates”) established by the IRS. However, prior guidelines provided that if such coverage was paid for by the employee’s own pre-tax salary reduction or by employer-provided flex credits and that amount was greater than the “Table I rate,” the employee would be taxed on the greater amount. Effective immediately, the employee should only be taxed on the “Table I rate.”

### **C. Flexible Spending Accounts**

Health care, dependent care and adoption assistance can all be provided pre-tax under a cafeteria plan. Most of the rules applying to these programs remain unchanged, including the requirement that elections cannot be changed during the coverage period. Mid-year changes in elections due to status changes are ONLY allowed if such changes are specifically allowed in the written document. A cafeteria plan that does not specifically allow these changes in its document cannot allow any changes at all during the year.

The proposed regulations largely incorporate the earlier guidance issued with regard to grace periods (i.e., allowing a participant to use amounts deferred but not used during the previous year to be applied to expenses incurred during the first 2 ½ months of the following year). The plan must expressly permit a grace period in writing or no grace period will be allowed under the plan. The terms of the grace period must be the same for all participants. For example, if a plan has a “limited use” only grace period in order to be HSA compatible, all participants (not just HSA participants) are subject to the limited use restriction. A new requirement expressly provides that a plan cannot allow a participant to use contributions for one benefit (such as the health care FSA) to be used to reimburse expenses incurred with respect to another benefit (such as adoption assistance) during the grace period.

The regulations also expressly allow the following:

- \* dependent care expenses incurred after an employee terminates employment with the employer may be reimbursed from the dependent care flexible spending account (plan must provide this in writing), and
- \* health care flexible spending account may reimburse orthodontia expenses after the dentist has been paid, even if services have not already been rendered.
- \* flexible spending account participants (health, dependent care, adoption assistance) who terminate employment on the last day of the plan year (e.g., December 31) or during the grace period (i.e., they were a participant in the plan on the last day of the plan year) can be reimbursed for expenses incurred after their termination of employment but before the end of the grace period (e.g., March 15) if the plan provides for a grace period.

### **D. Employee Elections**

The new proposed regulations permit a 30-day retroactive enrollment window for new employees. The salary reductions used to pay premiums for the retroactive coverage must come from pay that is not yet available to the employee at the time of the election. This applies only to

new employees. The regulations require that the plan document provide that an employee rehired within 30 days or an employee returning from an unpaid leave of absence within 30 days may not make a new election as if they are a new employee.

#### **E. Nondiscrimination Testing**

Cafeteria plans, and certain component plans that are normally funded through cafeteria plans such as dependent care and health care flexible spending accounts, are subject to nondiscrimination testing under current law. How this testing was to be done has never been clear, and many employers have simply not done it. The new proposed regulations attempt to provide additional guidance as to how to actually do the required nondiscrimination testing for cafeteria plans. Some of the guidance actually does clarify aspects of the testing and some of the guidance raises even more questions.

Following is a very brief overview of the requirements. If you need additional information about how to apply these requirements to your situation, please contact us.

First, the good news. The proposed regulations provide a safe harbor for certain premium-only cafeteria plans. A cafeteria plan that offers only an election between cash and pre-tax payment of the employee's share of the employer-provided accident and health insurance premium will automatically satisfy the nondiscrimination requirements IF: (1) It benefits a classification of employees found by the IRS not to discriminate in favor of highly-compensated participants; (2) no employee has to complete more than three years of service to participate, and (3) each employee can participate the first day of the plan year after meeting the service requirements. So, if you are an employer that offers a single health plan to all your employees (except nonresident aliens and union employees) at the same cost to all, you will automatically pass the test, even if most of the employees who actually enroll are highly compensated participants.

Otherwise, your cafeteria plan is subject to three nondiscrimination tests. First, the plan may not discriminate in favor of highly compensated individuals with regard to eligibility. Second, the cafeteria plan must not discriminate in favor of highly compensated participants with regard to contributions and benefits as to benefits availability. Third, the cafeteria plan must not discriminate in favor of highly compensated participants with regard to contributions and benefits as to benefits utilization. There are complicated percentage tests and facts and circumstances tests to be applied in each case.

The nondiscrimination testing must be done on the last day of the plan year, taking into account all non-excludable employees or former employees who were employees on any day during the plan year. If a cafeteria plan is discriminatory, all highly compensated participants in the plan must include in gross income the value of the taxable benefit with the greatest value that they could have elected (whether or not they actually elected that benefit).

Also note that employer contributions to employees' HSAs made through a cafeteria plan are also subject to nondiscrimination testing.

**F. Other**

The new proposed regulations provide that a salary reduction for an accident and health plan premium may be taken in the last month of a plan year to pay the premium for coverage for the first month of the following plan year.

**G. Action Points**

The following are actions you should take as a result of the new proposed regulations.

1. Review the written documentation for your cafeteria plan. If you do not have a discrete plan document that includes all the required provisions, you should adopt one as soon as possible.
2. Review your cafeteria plan to make sure you are not offering benefits that are not qualified benefits, such as legal services, life insurance for spouses and dependents, etc.
3. Consider conducting nondiscrimination testing on your plan if you have not been doing this testing.
4. Review the administration of your cafeteria plan to make sure it complies with what the plan document allows or requires. For example, make sure that any mid-year changes in status comply with the requirements both in the regulations and in your plan document.

Please let us know if you need assistance drafting a plan document, reviewing your plan document or your plan administration, or conducting nondiscrimination testing on your plan, or if you need additional information on this subject.

Very truly yours,

Sonja Lemmer Martens

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