



# MILLER & CHEVALIER

## EMPLOYEE BENEFITS ALERT



We partner with our clients in helping them navigate the vast array of laws and administrative agencies governing an employer's benefit and compensation practices.

On the planning side of our practice, we help clients find practical solutions in structuring employee benefit arrangements and executive compensation programs. Our comprehensive experience in the payroll tax and fringe benefit areas gives us a unique advantage in advising clients.

On the controversy side, our team has broad experience in handling tax controversy matters, and we pride ourselves on having one of the most dynamic ERISA litigation teams in the nation. We routinely help employers defend against individual and class action claims involving pension and health benefits plans as well as fiduciary litigation.

### IRS Issues New Proposed Cafeteria Plan Regulations

On August 3, the Internal Revenue Service (IRS) released new proposed regulations on cafeteria plans. Comments on the proposed regulations are due by November 5 and the IRS will hold a public hearing on the proposed rules on November 15. The rules - articulated in 124 pages - affect employers who sponsor a cafeteria plan, employees who participate in a cafeteria plan, and third-party cafeteria plan administrators. For the most part, the rules will take effect for plan years beginning on or after January 1, 2009; however, employers may begin relying on the rules immediately.

#### Background

A cafeteria plan allows an employee to choose between taxable benefits (typically cash) and non-taxable benefits. There are generally three types of cafeteria plans:

- A premium-only plan allows an employee to choose between salary and payment of the employee's premium contribution to participate in the employer's medical plan via tax-free salary reduction.
- A Flexible Spending Arrangement (FSA) allows an employee to elect to have a certain amount of money withheld tax-free from the employee's salary and to use the dollars to reimburse qualified health care, dependent care, or adoption assistance expenses.
- Under what is sometimes referred to as a flexible benefits plan, the employer may offer a menu of qualified tax-free and taxable benefits which the employee may elect to purchase with a combination of flex credits (employer contributions) and employee contributions.

Prior to the issuance of these new proposed regulations, cafeteria plans were governed by a limited set of final regulations and many proposed and temporary regulations, formatted as Q&As, dating back as far as 1984 which were never finalized. These rules were amplified by many private letter rulings, Notices, Revenue Rulings, and legislative history from various Acts passed by Congress. Often the rules were difficult to navigate, were implied instead of expressly stated, and did not provide enough information to give employers comfort that they were in compliance.

Further, the last significant guidance was proposed in 1989, and employer-sponsored benefit plan design and administrative practices have evolved significantly since then without any corresponding update to the cafeteria plan rules.

These new proposed regulations replace six previously issued proposed and temporary regulations, which the IRS has withdrawn. The new rules are clearly organized, provide many helpful examples, and consolidate applicable rules by incorporating other agency guidance, such as notices governing FSA grace periods, debit card substantiation, and Health Savings Accounts (HSAs.) The regulations clarify many features, such as the written plan document requirements, the application of the nondiscrimination rules, and the effect of noncompliance. They also reflect changes in tax law that have taken effect since the prior regulations were proposed. Pre-existing final regulations, governing applicability of COBRA to health FSAs, changes in elections related to the Family and Medical Leave Act, and qualified changes in status for mid-year election changes, remain untouched. Several other previously proposed rules are incorporated without significant changes, such as the rules governing FSAs and vacation days offered under a cafeteria plan. Employers are likely to have some additional questions and the IRS has specifically requested comments in several areas, including the question of how a multiple-employer cafeteria plan might work, the impact of change of status on a participant's uniform coverage amount, and how salary reduction cafeteria plan contributions might work with tip income. Hopefully the final regulations will incorporate guidance regarding these open items.

Below is a summary of the major sections of the proposed regulations, including comments on how the rules have changed:

- 1.125-1: Qualified and nonqualified benefits in a cafeteria plan
- 1.125-2: Elections in cafeteria plans
- 1.125-5: Flexible spending arrangements
- 1.125-6: Substantiation of expenses
- 1.125-7: Nondiscrimination rules

#### Recommended Employer Action

We recommend that employers take several steps now that the IRS has issued such comprehensive guidance governing cafeteria plans. These rules significantly expand and clearly

articulate what information must be included in an employer's written plan document. Further, the rules provide new, and seemingly stricter, standards and consequences regarding what benefits may be included in a cafeteria plan. The rules also clearly state that failing to comply with the written plan document requirement or failing to operate a cafeteria plan in accordance with the plan document or the regulations will result in the cafeteria plan election being included in gross income of the employee, regardless of whether the employee elected taxable or nontaxable benefits — clearly a catastrophic event for payroll tax purposes. Therefore, we recommend that, at the very least, employers review their current cafeteria plan documents and operational practices now for compliance with these rules. While the proposed effective date for these rules is not until the employer's plan year beginning on or after January 1, 2009, because the IRS has withdrawn most of the prior rules, these proposed and the other existing final regulations are, in effect, all the available guidance.

The regulations also include several new optional provisions employer may include in a cafeteria plan — for example, the rules regarding the payment of COBRA premiums. Employers may want to consider whether to take advantage of any such provisions for the upcoming plan year.

Finally, we recommend that employers review these rules, their current cafeteria plan, and any open questions they may have and consider submitting a comment letter to the IRS. The comment period and public hearing provide a meaningful opportunity for employers to help shape the rules and have any outstanding questions officially addressed.

### **1.125-1: Qualified and Nonqualified Benefits in a Cafeteria Plan**

#### ***Section 125 Exclusive Noninclusive Rule***

Section 125 provides generally that no amount shall be included in the gross income of the participant in a cafeteria plan solely because the participant may choose among benefits of the plan. The new rules clarify and amplify that Section 125 is the exclusive means by which an employer can offer employees a choice between taxable and nontaxable benefits without the choice itself resulting in the inclusion of gross income by the employees. Thus, any such election made outside of a qualified cafeteria plan will result in the inclusion of income to the participant. Prop. Reg. § 1.125-1(b)(1). This “exclusive means” rule potentially has negative implications for the typical negotiation that occurs in the employment contract and collectively bargained agreement setting, where the parties may effectively strike a balance between current pay and other benefits.

The rules also provide that, unless a plan satisfies the requirements of Section 125, the plan is not a cafeteria plan. Reasons that a plan would fail to satisfy the Section 125 requirements include the following:

- Offering nonqualified benefits;
- Not offering an election between at least one permitted taxable benefit (such as cash) and at least one qualified (nontaxable) benefit;
- Deferring compensation;
- Failing to comply with the uniform coverage or use-or-lose rule;
- Allowing employees to revoke elections or make new elections during a plan year, except as permitted under the change in status rules;
- Failing to comply with the substantiation requirements;
- Paying or reimbursing expenses incurred for qualified benefits before the effective date of the cafeteria plan or before a period of coverage;
- Allocating experience gains (forfeitures) other than as allowed in the new proposed rules; or
- Failing to comply with the grace period rules.

#### ***Definition of a Cafeteria Plan***

The new rules provide that a cafeteria plan is:

- A separate written plan that complies with Section 125 and the regulations;
- Maintained by an employer for employees; and
- Operated in compliance with the requirements of Section 125 and the regulations.

Plan participants must be allowed to choose between at least one taxable benefit (such as cash via salary reduction) and one qualified benefit. A plan offering only taxable benefits, or offering only nontaxable benefits, is not a cafeteria plan. Prop. Reg. § 1.125-1(a)(1). Thus, for example, a paid time off plan that allows participants to elect prospectively between additional future leave and cash would not qualify as a cafeteria plan, although the arrangement might be subject to Section 409A.

#### ***Written Plan***

A cafeteria plan must be in writing and the plan must be operated in accordance with plan terms. Prop. Reg. § 1.125-1(c). The new regulations provide that noncompliance with these rules means that the plan is not a cafeteria plan and the employee's entire election will be included in gross income, regardless of whether he elected taxable or nontaxable benefits. Prop. Reg. § 1.125-1(c)(6) and (7).

The new requirements regarding what must be included in the written plan document are significantly expanded from prior rules. Prop. Reg. § 1.125-1(c). A cafeteria plan document must:

- Specifically describe all benefits;
- Set forth rules for eligibility to participate and the procedure for making elections;
- Provide that all elections are irrevocable (except to the extent the plan includes the optional change in status rules);
- State how employer contributions may be made under the plan (including salary reduction or nonelective employer contributions);
- State the maximum amount of elective contributions allowed;
- State the plan year; and
- Specify that only employees may participate in the plan.

If the plan includes an FSA, the written plan must also include the uniform coverage rule (that all contributions under a health FSA be available throughout the election period, less any claims already reimbursed) and the use-or-lose rule. The new rules also require that all provisions of the plan apply uniformly to all participants. It is not quite clear what the scope of the “uniform terms” requirement is, and how that requirement might affect the ability to include different benefits under the plan. Presumably, under these rules, a plan is the document or set of documents designated as such by the employer.

#### ***Individuals Who May Participate in a Cafeteria Plan***

All cafeteria plan participants must be employees. The new regulations provide that employees include common law employees, leased employees, and full-time life insurance salesmen. The rules reiterate that former employees may participate, but a plan may not be maintained predominantly for former employees, and newly references laid-off and retired individuals as former employees. Prop. Reg. § 1.125-1(g)(1).

Self-employed individuals are not employees for the purposes of Section 125. The new regulations clarify that sole proprietors, partners, directors of corporations, and 2-percent shareholders of an S corporation are not employees and may not participate in a cafeteria plan. Violation of the coverage rule presumably taints the entire plan, so that employers that include in their plans employees or full-time

life insurance salesmen who are not properly qualified as such will risk undermining the qualified status of their cafeteria plans. The new regulations provide rules for dual status individuals who are also employees and individuals moving between employee and non-employee status. A self-employed individual may sponsor a cafeteria plan for his employees. Prop. Reg. § 1.125-1(g)(2).

The new regulations restate the rule from Code Section 414 that all employees of two or more employers that are members of a controlled group are treated as employed by a single employer for purposes of Section 125. Prop. Reg. § 1.125-7(i). As noted above, the IRS has requested comments on whether, consistent with Code Section 125, multiple employers other than members of a controlled group may sponsor a single cafeteria plan.

#### ***Election between Taxable and Nontaxable Benefits***

The new rules require that a cafeteria plan offer employees an election among only permitted taxable benefits (including cash) and qualified nontaxable benefits. Prop. Reg. § 1.125-1(a)(1). The new rules define cash to include the following:

- Current compensation (including salary reduction);
- Payment for annual leave, sick leave, or other paid time off;
- Severance pay;
- Property;
- Employer-provided benefits that are taxable to the employee; and
- Certain after-tax employee contributions. Prop. Reg. § 1.125-1(a)(2).

As previously noted, the IRS has requested comments regarding whether salary reduction contributions may be based on employees’ tips and how that would work. Absent from this list are qualified retirement plan benefits and presumably other forms of deferred compensation (other than severance pay), so these forms of pay may not be used in connection with a cafeteria plan. It should be noted that “severance pay” is not defined for these purposes.

#### ***Qualified Benefits***

In order to be a qualified benefit under Section 125, the benefit must be excludible from the employee’s gross income under a specific provision of the Code and must not defer compensation (except as specifically allowed under Section 125.) Prop. Reg. § 1.125-1(a)(3). The new rules restate that the following are qualified benefits:

- Group-term life insurance covering the employee;
- Employer-provided accident and health plans;

- Short-term and long-term disability benefits;
- Dependent care FSAs; and
- Contributions to a 401(k) plan.

In addition, the proposed regulations now expressly include the following as qualified benefits:

- COBRA premiums;
- Health FSAs;
- Accidental death and dismemberment policies;
- Adoption assistance programs;
- Contributions to HSAs; and
- Contributions to certain plans maintained by educational organizations.

Note that a legal services plan is no longer a qualified benefit.

#### ***Group-Term Life Insurance***

Under Code Section 79, the cost of group-term life insurance for the employee provided directly or indirectly by the employer is excludible from the employee's income up to \$50,000. The amount of group-term life insurance provided to the employee (both through and outside of the cafeteria plan) above \$50,000 will be included in the employee's gross income. The new regulations provide that the cost of group-term life insurance, whether greater or less than \$50,000, so long as not combined with any permanent benefit, may be offered through a cafeteria plan. Further, the new regulations provide that any amount of salary reduction and employer flex-credits for group-term life insurance, whether or not the coverage exceeds \$50,000, will be excluded from the employee's income. The rules then provide a formula for how to calculate the appropriate amount to be included in the employee's gross income for coverage in excess of \$50,000. Prop. Reg. § 1.125-1(k). This is a change from the prior rules articulated in Notice 89-110 providing that the total amount includible in the gross income of an employee who receives employer-provided group-term life insurance under a cafeteria plan is the greater of the employee's contributions toward the purchase of the insurance or the cost of the insurance determined under Code Section 79. While the effective date of the proposed regulations is generally plan years beginning on or after January 1, 2009, this rule with regard to the calculation of participant income is effective as of the date the proposed regulation are published in the Federal Register, which therefore will affect how 2007 W-2's are prepared. Prop. Reg. § 1.125-1(s).

#### ***Accident and Health Plans***

An employer-sponsored health plan is a qualified benefit under a cafeteria plan. In addition, the new rules specifically permit a cafeteria plan (but not a health FSA) to pay or reimburse substantiated individual policy accident and health insurance premiums. Prop. Reg. § 1.125-1(m). In other words, an employee may purchase an individual health insurance policy providing single or family coverage, elect to have the employer reduce the employee's salary on a pre-tax basis, and be reimbursed for the insurance premiums (after properly substantiating the expenses consistent with the general substantiations requirements detailed in the regulations.) This rule incorporates Revenue Ruling 61-146, which has received much attention in light of the new Massachusetts health reform that took effect July 1, 2007. The Massachusetts law, among other things, requires employers to sponsor a premium-only cafeteria plan in order to allow employees who do not have coverage under the employer's health plan to purchase an individual policy through the State and to pay those premiums pre-tax via salary reduction.

In addition, the new regulations allow the employee or former employee to make a pre-tax election to pay for COBRA premiums. Prop. Reg. § 1.125-1(l). This includes COBRA payments for coverage under a former employer's plan or for the employer sponsoring the cafeteria plan (for example, the employee may elect to reduce severance payments in order to pay for COBRA coverage.) If the coverage is under a former employer's plan, the regulations do not address whether making such contributions would make the payor a co-sponsor of the former employer's plan. The employer may also allow after-tax contributions for COBRA premiums, for example for a former spouse.

#### ***Contributions to a 401(k) Plan through a Cafeteria Plan***

The new rules clarify the interaction between Code Sections 125 and 401(k). Prop. Reg. § 1.125-1(o)(3). 401(k) plan contributions expressed as a percentage of compensation are allowed in a cafeteria plan. Prop. Reg. § 1.125-1(c)(1)(v)(B). Further, elective 401(k) contributions may be made through automatic enrollment if an employee does not affirmatively elect to receive cash. It is unclear exactly how the 125 and 401(k) automatic enrollment rules will fit together. See Treas. Reg. § 1.401(k)-1(a)(3)(ii).

#### ***After-Tax Employee Contributions***

The new rules still allow a cafeteria plan to offer after-tax employee contributions for any qualified benefits (which are typically purchased with pre-tax dollars) or paid time off. The

new rules specifically accommodate the purchase of domestic partner coverage through a cafeteria plan, and provide a description of how such coverage is taxed, confirming prior PLRs. Prop. Reg. § 1.125-1(h)(2). However, now a cafeteria plan may only offer the taxable benefits specifically permitted in the new rules. Prop. Reg. § 1.125-1(i) and (q). Nonqualified benefits may not be offered through a cafeteria plan, even if paid with after-tax employee contributions. The consequence of doing so is that the employee's entire cafeteria plan election between taxable and nontaxable benefits election must be included in the employee's gross income. Accordingly, it will be important to provide in a separate "plan" for the purchase of nonqualified benefits.

#### ***Paid Time Off***

Under the prior rules, permitted taxable benefits included various forms of paid leave. The new rules consolidate vacation days, sick leave, and personal days into a single category of "paid time off". The new rules include the same ordering rule: an employee will be deemed to have used nonelective time before using elective time and any elective time not used by the end of the year must be forfeited or paid in taxable cash. If paid in cash, the employee must receive the cash on or before the last day of the plan year to which the contributions relate. Prop. Reg. § 1.125-1(o)(4).

#### ***Nonqualified Benefits***

The rules restate that a cafeteria plan must not offer as a benefit any of the following:

- Scholarships;
- Educational assistance under Code Section 127;
- Fringe benefits (which includes such things as working conditions fringe benefits); or
- Employer-provided meals and lodging.

The new rules now specifically state that the following are also nonqualified benefits:

- Archer Medical Savings Accounts (MSAs);
- Health Reimbursement Arrangements (HRAs);
- Elective deferrals to 403(b) plans;
- Group term-life insurance for an employee's spouse, child, or dependent; or
- Group term-life insurance for an employee's spouse, child, or dependent; or
- Long-term care insurance. (In addition, long-term care services are not qualified expenses, although an HSA funded through a cafeteria plan may be used to pay for long-term care insurance premiums or for long-term care expenses.) Prop. Reg. § 1.125-1(q).

#### ***Plan Year***

The new rules require a cafeteria plan to be 12 consecutive months and must be set forth in the written plan document. Prop. Reg. § 1.125-1(d). A short plan year (or change in plan year resulting in a short plan year) is only permitted for a valid business purpose. Examples in the new rules illustrate that implementing a calendar year plan mid-year or changing the plan mid-year in conjunction with a change in health insurance carrier would both have valid business purposes. Other changes, including a change in plan year to circumvent the cafeteria plan rules, are ineffective.

#### ***Grace Period***

The new rules incorporate the prior Notices allowing a grace period for incurring expenses for qualified benefits, typically FSAs. Prop. Reg. § 1.125-1(e). A grace period is an optional feature that an employer may include in a cafeteria plan. The grace period may be up to 2 ½ months from the end of the plan year. The grace period is not allowed for paid time off or 401(k) plan contributions. The grace period applies to anyone who is a participant (including through COBRA) on the last day of the plan year; even if a person terminates before the end of the grace period, he must be allowed to incur claims to the end of the grace period if he was a participant on the last day of the plan year. Notice 2005-86 (governing coordination of a health FSA with a grace period and an HSA) and Notice 2005-61 (providing information on Form W-2 reporting for dependent care expenses incurred during a grace period) are both still in effect.

#### ***No Deferral of Compensation***

As a general rule, 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 year. Prop. Reg. § 1.125-1(o). The new rules clarify when certain practices defer compensation. For example, the regulations permit an accident or health insurance policy to provide the following benefit features that apply for more than one year:

- Credit toward the deductible for unreimbursed covered expenses incurred in prior periods;
- Reasonable lifetime limits on benefits;
- Level premiums;
- Premium waiver during disability;
- Guaranteed renewability of coverage (but not guaranty of the amount of premium upon renewal);
- Coverage for specified accidental injury or specific diseases; and
- Payment of a fixed amount per day for hospitalization. Prop. Reg. § 1.125-1(p).

These insurance policies must not provide an investment fund or cash value to pay premiums and no part of the premium may be held in a separate account for the beneficiary. Prop. Reg. § 1.125-1(p)(1)(ii).

The new rules also provide that the following benefits and practices do not defer compensation:

- A long-term disability policy paying benefits over more than one year;
- Reasonable premium rebates or policy dividends;
- Mandatory two-year lock-in vision and dental policies; or
- Salary reduction during the last month of a plan year to pay accident and health premiums for the first month of the following year. Prop. Reg. § 1.125-1(p).

Finally, the health FSA rules restate that the following are permissible reimbursements without violating the prohibition on deferral of compensation:

- Certain advance payments for orthodontia;
- Reimbursement of qualified durable medical equipment; and
- Allocation of experience gains (forfeitures) among participants. Prop. Reg. §§ 1.125-5(k)(3) and 1.125-1(o).

Interestingly, the rules do not include advance payments for infertility treatments as a qualified expense; many employers have questioned whether such expenses could be permissible as the market is requiring advance payments similar to the practice for orthodontia.

### ***Salary Reduction Contributions***

The proposed regulations restate that an employee may elect to forego salary (via salary reduction) and instead receive a nontaxable benefit, and that such benefit is deemed to be provided by employer contributions. Prop. Reg. § 1.125-1(r). The new rules specifically allow an employer to require employees to pay their share of any qualified benefit through pre-tax salary reduction and not with after-tax employee contributions. The new rules also allow a cafeteria plan to impose reasonable fees to administer the plan, which may be paid through salary reduction. Finally, the new rules provide that a cafeteria plan is not required to allow employees to pay for any qualified benefit with after-tax employee contributions.

### **1.125-2: Elections in Cafeteria Plans**

#### ***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 must generally be irrevocable through the year. A cafeteria plan may provide for mid-year changes in election based on certain qualified changes in status. The new rules require an employer that wants to allow such mid-year changes to incorporate the rules of Treas. Reg. § 1.125-4 in its written cafeteria plan. The new rules also clarify that only an employee, not the employee's spouse, dependent, or any other individual, may revoke or change elections under the plan. Prop. Reg. § 1.125-2(a).

#### ***HSA Contributions***

The general rule is that cafeteria plan elections are irrevocable for the plan year unless the employee has a qualified change in status. An exception incorporated into these new rules applies to HSAs. Prop. Reg. § 1.125-2(c). If HSA contributions are allowed to be made through salary reduction under a cafeteria plan, the employer must:

- Describe the HSA contribution benefit in the plan document;
- Allow the participant to prospectively change his salary reduction election on a monthly basis (or more frequently); and
- Allow a participant who becomes ineligible to contribute to an HSA to prospectively revoke his election.

Note that allowing participants to make these mid-year changes is mandatory, not optional. Therefore, any employer electing to offer an HSA through a cafeteria plan will be required to amend its cafeteria plan document.

#### ***Form of Elections***

The prior rules did not provide detail regarding the form a cafeteria plan election must take. The new rules specifically allow for electronic elections and provide that the safe harbor in Section 1.401(a)-21 is available. Prop. Reg. § 1.125-2(a)(5).

The new rules also specifically allow for automatic elections. Prop. Reg. § 1.125-2(b). A negative election is allowed if an employee does not return an enrollment form when first eligible; for example, the employer will automatically enroll the employee in self-only employer-sponsored health plan coverage. An evergreen election is allowed if an employee does not make an election during open enrollment, so that the election the employee made for a prior year will be deemed to continue for every succeeding plan year, unless changed. Allowing automatic elections is permissible, not required.

Prior rules mandated a 12-month coverage period for FSAs, which appeared more rigid than the safe harbor for 12 months of coverage applicable to health plans generally. See withdrawn Prop Reg. § 1.125-2, Q&A 7(b)(6) and withdrawn Prop. Reg. § 1.125-1, Q&A 17. In the absence of specific guidance to the contrary, many benefits practitioners read this to require an affirmative annual FSA election. The new regulations set forth the general rule allowing for automatic evergreen elections and do not state any exceptions for FSAs. Therefore, it appears that an employer may now allow for evergreen elections for FSAs as well as other benefits.

#### ***Optional Election for New Employees***

The new rules also permit a cafeteria plan to provide an optional election for new employees between cash and qualified benefits. Prop. Reg. § 1.125-2(d). New employees may make an election within 30 days after the date of hire and the benefits may be retroactive to the date of hire (although the election must be paid for from compensation not yet available on the date of the election.) This new election opportunity does not apply to an employee who terminates employment and is rehired within 30 days (or who returns following an unpaid leave of absence of less than 30 days.) The written plan document must explicitly provide for the foregoing rules if such elections are offered.

#### **1.125-5: Flexible Spending Arrangements**

The new regulations retain many of the existing rules governing health, dependent care, or adoption assistance FSAs, including the following:

- Uniform coverage: the maximum amount of reimbursement from a health FSA must be available at all times during the coverage period;
- Use-or-lose: any contributions not spent by the end of the year (or grace period, if applicable) must be forfeited;
- The period of coverage must be 12 months, with an exception for a short plan year that satisfies the new rules; and
- Expenses incurred before or after the coverage period may not be reimbursed. Prop. Reg. § 1.125-5.

#### ***Period of Coverage***

The new rules clarify the beginning and end of a period of coverage. A cafeteria plan may only reimburse substantiated expenses for qualified benefits incurred on or after the later of the effective date of the cafeteria plan and the date the employee is enrolled in the plan. Prop. Reg. § 1.125-6(a)(1). The new rules also clarify that FSAs for different qualified benefits do not need to have the same coverage period. Prop. Reg. § 1.125-5(e). It is unclear how different coverage

periods for different benefits would work in practice or what advantage it would provide to the employer or employees. It is also unclear how the rule prohibiting deferred compensation applies where the coverage period is different from the plan year.

#### ***Health Care Expenses***

A health FSA may only reimburse certain substantiated Code Section 213(d) medical expenses incurred by the employee, the employee's spouse or dependents. The new rules clarify that a health FSA may be limited to a subset of permitted Section 213(d) medical expenses (for example, a health FSA may exclude reimbursement for over-the-counter drugs.) Prop. Reg. § 1.125-5(k)(2). Further, the new rules clarify that the medical expenses are incurred when the services are provided, not when billed or paid. Prop. Reg. § 1.125-6(a)(2).

The new regulations also incorporate rules governing limited-purpose or post-deductible FSAs offered in conjunction with an HSA as established in Revenue Ruling 2004-45 and Notice 2005-86. Prop. Reg. § 1.125-5(m).

#### ***Qualified Distributions to HSAs***

The new regulations incorporate the rules on qualified transfers from FSAs to HSAs set forth in Notice 2007-22. Such distributions are authorized between December 20, 2006 and December 31, 2011. This provision is only available to individuals who were participating in and had a positive cash-basis balance in the employer's health FSA as of September 21, 2006. Prop. Reg. § 1.125-5(n)(1). An employer must amend its cafeteria plan in order to take advantage of this provision. Prop. Reg. § 1.125-5(n)(1). Also note that Notice 2007-22, which presumably still applies, provides strict operational rules required to protect the tax-free status of the transfer which will have to be satisfied.

#### ***Dependent Care Assistance***

In general the new regulations restate the general rules for providing dependent care FSAs through a cafeteria plan. The substantiation rules, discussed below, provide detailed information on when dependent care expenses are incurred and the use of debit cards for reimbursing such expenses. Prop. Reg. § 1.125-6. A new optional rule permits an employer to reimburse a terminated employee's qualified dependent care expenses incurred after termination. Prop. Reg. § 1.125-6(a)(4)(v). Such provision must be included in the written plan document.

***Experience Gains (Forfeitures)***

Unused FSA amounts forfeited under the use-or-lose rule are referred to as experience gains. The new rules retain the forfeiture allocation rules under the prior proposed regulations and clarify that the employer sponsoring the cafeteria plan may retain forfeitures, use forfeitures to defray expenses of administering the plan, or allocate forfeitures among employees contributing through salary reduction on a reasonable and uniform basis. Prop. Reg. § 1.125-6(o).

***FSA Administrative Rules***

The new rules specifically allow a cafeteria plan to limit enrollment in a health FSA to those employees who participate in the employer's accident and health plan. Prop. Reg. § 1.125-5(g)(1).

The new rules also permit the cafeteria plan to specify any interval for employee's salary reduction contributions, so long as they apply uniformly to all participants. Prop. Reg. § 1.125-5(g)(2). For example, the contributions could be made ratably over the plan year on the employer's payroll periods or in equal installments at other regular intervals (such as quarterly).

**1.125-6: Substantiation of Expenses*****Incurring and Reimbursing Expenses for Qualified Benefits***

The new rules provide that only expenses for qualified benefits incurred after the later of the effective date (or adoption date) of the plan and the date the employee is enrolled are permitted to be reimbursed. Prop. Reg. §§ 1.125-6(a)(1) and 1.125-1(c)(7)(ii)(A). Similarly, if a plan amendment adds a new benefit, only expenses incurred after the later of the effective date or the adoption date of the amendment are eligible for reimbursement. Prop. Reg. § 1.125-1(c)(7)(ii)(A). Further, a plan may only pay or reimburse expenses for qualified benefits incurred during a participant's period of coverage. Prop. Reg. § 1.125-6(a)(2).

***Substantiation and Reimbursement of Expenses for Qualified Benefits***

The new rules, which incorporate previously issued guidance from prior Revenue Rulings and Notices, provide that, after an employee incurs an expense for a qualified benefit during the coverage period, the expense must first be substantiated before the expense may be paid or reimbursed. Prop. Reg. § 1.125-6(b). All expenses must be substantiated; substantiating only a limited number of total claims (e.g., using a sampling approach) or not substantiating claims

below a certain dollar amount does not satisfy the requirements of the new proposed regulations. Prop. Reg. § 1.125-6(b)(2).

Further, expenses must be substantiated by an independent third-party; self-substantiation or self-certification of an expense is not allowed. Prop. Reg. § 1.125-5(b)(3). The new rules provide that all amounts paid under a plan that permits self-substantiation or self-certification are includable in gross income, including amounts already reimbursed, whether or not substantiated. Inasmuch as some vendors have been employing payment procedures that may approach self-substantiation, employers will want to review their cafeteria plan's current payment procedures closely.

***Debit Cards***

The new rules incorporate previously issued guidance on substantiating, paying, and reimbursing expenses for Code Section 213(d) medical care incurred at a medical provider or retail outlet when payment is made with a debit card. Prop. Reg. § 1.125-6(d). A health FSA reimbursing Section 213(d) expenses through a debit card must satisfy all of the following requirements:

- Before receiving the debit card, the employee must agree in writing that the employee will:
  - Only use the card to pay for medical expenses;
  - Not use the card for any expenses that have already been reimbursed;
  - Not seek reimbursement under any other health plan for any expenses paid with a debit card; and
  - Acquire and retain sufficient documentation for any expenses paid with a debit card;
- The debit card includes a statement providing the above agreements are reaffirmed each time the employee uses the card;
- The amount available through the card equals the amount elected by the employee for his annual FSA contribution and is reduced by amounts reimbursed under the plan;
- The card is automatically cancelled when the employee ceases plan participation;
- The employer limits use of the card to:
  - Medical service providers;
  - Stores with the merchant category code for Drugstores and Pharmacies if, on a location by store location basis, 90% of the store's gross receipts during the prior year consisted of items which qualify as 213(d) expenses (including over-the-counter drugs); and

- Stores that have implemented the inventory information approval system described in Notice 2006-69;
- The employer substantiates claims in accordance with the regulations; and
- The employer follows all correction procedures for improper payments. Prop. Reg. § 1.125-6(d).

The transition rule provided in Notice 2007-2 is still applicable and provides that, for health FSA debit card transactions occurring on or before December 31, 2007, all supermarkets, grocery stores, discount stores, and wholesale clubs that do not have a medical care merchant category code are nevertheless deemed to be an allowable medical provider where debit cards may be used. During this time, mail-order vendors and web-based vendors that sell prescription drugs are also deemed to be allowable medical providers. For 2008 a special transition rule applies. After December 31, 2008, cafeteria plans must comply with the rules as restated in the proposed regulations and only allow debit cards to be used at the type of stores described above.

Permissible substantiation methods are copayment matches, recurring expenses, and real-time substantiation. The new rules also allow point-of-sale substantiation through matching inventory information with a list of 213(d) medical expenses. The employer is responsible for ensuring that the inventory information approval system complies with the new regulations and with the recordkeeping requirements in Code Section 6001; it is unclear how the employer will accomplish this from a practical standpoint. Finally, the employee may pay for certain expenses with a debit card pending confirmation of the charges through third-party information. If the charges are not subsequently substantiated, the employer must follow specified correction procedures to recover the improperly paid amount.

The new regulations also incorporate the rules under which an FSA may pay or reimburse dependent care expenses using debit cards. Prop. Reg. § 1.125-6(g). Expenses may not be reimbursed before the services are provided, even if the day care provider requires advance payment. For example, a payment made on July 1 to cover dependent care expenses for July 1 through July 31 may not be reimbursed until July 31. The rules do allow for simplified substantiation of recurring claims and provide direction for making funds available on a debit card consistent with a regular payment schedule of dependent care expenses. However, creating individualized schedules for funds to become available on a participant's debit card as described in the regulations seems unworkable from a practical standpoint.

Debit cards for FSAs are not widely used in the market today because of the complexity in these substantiation rules. Employers and administrators who had hoped the IRS would soften the debit card substantiation requirements will likely be disappointed by these proposed regulations. Note that debit cards are working successfully for HSAs as employees are not required to substantiate those claims before being reimbursed but rather must simply maintain health care receipts in case of IRS audit.

### **1.125-7: Nondiscrimination Rules**

Discriminatory benefits provided to highly compensated participants and key employees are included in these employees' gross incomes. Prop. Reg. § 1.125-7. The new rules reflect changes in tax law since 1984, including the key employee concentration test, statutory nontaxable benefits, and the change in definition of dependent.

The new rules provide additional, and much needed, guidance on the cafeteria plan nondiscrimination rules and adopt many of the standards currently applicable to qualified deferred compensation arrangements, such as 401(k) plans. The new rules define several key terms, including highly compensated individual, officer, five percent shareholder, key employees, and compensation. While, under the new rules, these terms resemble in certain aspects their counterparts under the qualified retirement plan rules, there are still differences — e.g., “highly compensated individuals” include all officers. The new rules also provide guidance on the nondiscrimination as to eligibility requirement by incorporating a number of the rules under Code Section 410(b) dealing with reasonable classification, the safe harbor percentage test, and the unsafe harbor percentage component of the facts and circumstances test. In general, the new rules will require employers to count for these purposes employees who have not completed three years of employment if the plan allows any employee with less than three years of service to participate.

The new rules provide additional guidance on the contributions and benefits test and, unlike the prior rules, provide an objective test to determine when the actual election of benefits is discriminatory. Specifically, the new rules provide that under the benefits test a cafeteria plan must give each similarly situated participant a uniform opportunity to elect qualified benefits and that highly compensated participants must not actually disproportionately elect those benefits. For these purposes, the rules define disproportionate utilization to mean a situation in which the aggregate qualified benefits elected by highly compensated participants, calculated as a

percentage of aggregate compensation, exceed the aggregate qualified benefits elected by nonhighly compensated participants. Finally, the new rules provide guidance on the safe harbor for cafeteria plans providing health benefits and create a safe harbor for premium-only plans that satisfy certain requirements.

The new rules require employers to perform nondiscrimination testing as of the last day of each plan year. The rules indicate that in applying the test, the employer must take into account all non-excludable employees (or former employees) who were employees on any day during the plan year. Prop. Reg. § 1.125-7(j).

While the nondiscrimination rules do establish several definitions, tests, and safe harbors that will be easier to apply than the prior rules, employers are still likely to have open questions regarding the operation of these rules. The IRS has requested comments on the clarity of the proposed rules generally and how they can be made easier to understand; perhaps additional detail and examples regarding nondiscrimination would be helpful. For instance, the proposed regulations include several examples illustrating the nondiscrimination in eligibility standards. Prop. Reg. § 1.125-7(b). The fourth example provides that the employer's cafeteria plan offers two employer-provided health insurance plans:

- Plan X is a low-deductible plan available to highly compensated participants with a premium of \$15,000 per year;
- Plan Y is a high-deductible plan available to nonhighly compensated participants with a premium of \$8,000 per year.

All participants (highly and nonhighly compensated) may elect \$8,000 of salary reduction for coverage under their respective plans. The proposed regulations conclude that this arrangement fails the eligibility test. It is common practice for an employer to offer one health plan for its rank-and-file employees (either insured or self-funded) and a more generous, insured plan for its highly compensated individuals. Typically the determination of whether such arrangement is discriminatory has been analyzed under the rules in Code Section 105(h) governing self-funded health plans. The example in the new proposed regulations implies that both Plans X and Y are insured plans, which would satisfy Code Section 105(h). If the new regulations really do prohibit such an arrangement, many employers will be required to make significant changes to their current health plan offerings.

### **For Further Information**

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