

IRS New Proposed Cafeteria Plan Regulations

The Bottom Line

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“Hurry Up and Wait!”

Definition: “to prepare quickly for an activity that is then delayed.”

That old American idiom best describes the IRS new proposed Cafeteria Plan regulations. You no doubt have heard some rumblings these past few months regarding upcoming changes to these regulations. The new proposed cafeteria plan regulations published on August 6, 2007 consolidate and update a 23-year patchwork of proposed and temporary regulations, rulings and notices with respect to cafeteria plans.

If you have a Section 125 plan, this executive summary is intended to provide you with the key provisions and highlights of the new proposed regulations now, before any potential changes made in response to a mountain of public comments.

Highlights addressed in the proposed regulations include the following:

General Requirements

- Written Plan Document - now required. Also, if offered, the plan must contain certain rules pertaining to paid time off, FSAs, grace periods & distributions from a health care FSA to a Health Savings Account (HSA).
- HSA Contributions - may be made prospectively on at least a monthly basis and may be revoked.

Qualified, Taxable and Non-Qualified Benefits

- Expansion of qualified benefits now includes adoption assistance and HSAs. Nondiscrimination rules apply to each benefit.
- Group Term Life Insurance over \$50,000 - Determination of the taxable amount is revised.
- Non-qualified benefits not permitted under a cafeteria plan include scholarships; educational assistance; fringe

benefits, long-term care insurance; health reimbursement arrangements (HRA) and others.

Flexible Spending Accounts

- Uniform Coverage Rules apply only to health care FSAs. The maximum amount of reimbursement must be available at all times during the period of coverage, not just the amount contributed. Contributions may not be accelerated based on an employees' incurred claims.
- Use-It or Lose-It Rule - remains intact, no change.
- Grace Period - some new optional features, i.e.:
 - May apply to some qualified benefits and not others
 - Limit the amount of unused contributions available during the grace period as long as applied uniformly to all participants
 - Be less than 2 ½ month
 - Apply unused contributions from the prior year to reimburse grace period expenses first and then use current year contributions.
- Run-out Period - no change. May use a run-out period after the grace period as long as applied uniformly to all participants.
- HSA-Compatible FSAs - limited purpose health care FSAs and post-deductible health care FSAs may be offered through a cafeteria plan. Confirms that an individual cannot contribute to an HSA if covered by a general purpose health care FSA. If covered by a high deductible health plan (HDHP), individual is eligible for an HSA if also covered by a limited-purpose FSA or post-deductible health care FSA.
- Qualified HSA Distributions - Direct rollover distributions from an FSA to an HSA are allowed if:
 - a. No previous distribution;
 - b. Employer makes the distribution;
 - c. Cash limits on distribution and made no later than December 31, 2011.
- Expense Substantiation - generally the same except employer may permit dependent care expenses incurred between the employee's date of termination and the end of the plan year plus grace period. This “optional spend down

provision” must be incorporated in the written cafeteria plan document and does not apply to a health care FSA. Existing expense substantiation still applies with stronger emphasis.

- Debit Card Use - stronger requirements as to use and correction procedures.

Nondiscrimination Requirements

- Generally, new proposed regulations consolidate previous guidance on the nondiscrimination testing of cafeteria plans, but will be significantly more burdensome and similar to tests applicable to 401(k) plans. This includes new definitions for several key terms used in testing; guidance on eligibility requirements as it relates to coverage testing; new objective test to determine when the actual election of benefits is discriminatory; and new safe-harbor for certain premium-only plans.
- Administrative Details - testing must be performed on the last day of the plan year taking into account all non-

excludable or former employees on any day during the plan year. If testing found discriminatory, affected individuals must include in gross income the value of the taxable benefit with the greatest value that the employee could have elected.

Employer contributions to employees’ HSAs are also subject to nondiscrimination rules.

Effective Date of Changes: January 1, 2009

Even though it has taken over 20 years for the IRS to consolidate previous proposed and temporary regulations, we now have a fresh set of regs that restates much of the old proposed regulations. Look for Laurus Strategies to unravel and provide additional guidance on the foregoing subject matter in the months ahead.

Should you have any questions, please contact your Laurus Strategies Client Manager.

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