

IRS Revives Long-Dormant Cafeteria Plan Rules With New Proposed Regulations

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The Internal Revenue Service (IRS) recently withdrew numerous old proposed cafeteria plan regulations and guidance, some of which dated all the way back to 1984, and issued five new proposed regulations that update and expand the rules that govern the design, operation, and nondiscrimination rules applicable to cafeteria plans under Internal Revenue Code section 125. The repropounded regulations are expected to apply to plan years beginning on or after January 1, 2009 but can be relied on in the interim.

The new proposed regulations establish the critical tax framework that allows employees to choose between taxable and nontaxable benefits without triggering taxable income. The regulations emphasize that the cafeteria plan rules are the exclusive means by which employees can make that choice and that the mere opportunity to make such a choice will result in undesirable taxation unless a cafeteria plan satisfies all of the requirements of section 125 and the proposed regulations.

Due to the adverse income tax consequences associated with failing to meet the cafeteria plan rules, all employers that offer employees a choice between taxable and nontaxable benefits will need to pay close attention to the restated, updated, and expanded concepts in the new proposed regulations.

The new proposed regulations retain longstanding cafeteria plan rules and concepts such as:

- Use-it-or-lose-it rule for spending accounts
- Uniform coverage rule for health FSAs
- Irrevocable elections (except for a change in status)
- Twelve-month plan year
- Prohibition on deferred compensation
- Written plan requirements (with 10 specific required provisions)
- Limitation of participation to employees
- Qualified taxable benefits and qualified nontaxable benefits
- Prohibited nonqualified benefits
- Paid-time-off ordering rules

The new proposed regulations also incorporate recent developments such as:

- Adoption assistance programs
- Revised dependent definitions

- Grace period for spending accounts
- Electronic elections
- HSAs
- Substantiation of expenses
- Debit card rules
- Key employee concentration test

Finally, the new proposed regulations introduce new or significantly expanded rules such as:

- Immediately changing imputed income rules for group term life coverage to include only the Table 1 cost of the coverage in excess of \$50,000
- Allowing pretax premium payment (but not health FSA payment) of individual accident and health insurance premiums
- Permitting a short plan year for valid business purposes
- Allowing default elections for new or current employees
- Creating a 30-day grace period for new elections (thus partially addressing the old pretax retroactive deduction problem)
- Permitting dependent care spending accounts to reimburse expenses incurred after termination of employment
- Paying cafeteria plan administrative fees through salary deductions
- Paying for January coverage with December wages
- Recognizing that employers may keep experience gains (often called forfeitures)
- Greatly expanded nondiscrimination rules for eligibility (as well as contributions and benefits) that borrow some retirement plan concepts and, significantly, provide an objective test to determine whether elected benefits are discriminatory. As a consequence, cafeteria plans will have to show each year that the utilization of benefits by highly compensated participants is not discriminatory

While the new regulations will undoubtedly change to some degree as they make their way through the comment and hearing process, they represent a significant investment in time and attention by the IRS. As a result, employers should anticipate that cafeteria plans will begin to receive more attention on audit by the IRS and may even spawn detailed annual nondiscrimination testing requirements (perhaps even similar to 401(k) plans). Regardless, employers will have to pay far more attention to the design, operation, and documentation of their cafeteria plans than ever before.

The IRS will hold a public hearing on the new proposed regulations on November 15, 2007. Interested parties that wish to speak at the hearing must submit an outline of topics by October 25, 2007. Interested parties may also submit written comments on the new regulations by November 5, 2007. The IRS has also invited comments on the clarity of the rules, multiple-employer cafeteria plans, contributions based on tips, and uniform coverage issues related to status changes.

The IRS will issue final regulations after receiving written comments and conducting the public hearing. While this means, as a practical matter, that final regulations will not apply to cafeteria plans until, at the earliest, the 2009 open-enrollment process, employers can rely on the repropoed regulations in the interim. Employers can also take immediate advantage of the group term life imputed income change, as well as new concepts such as short plan years, automatic elections, and retaining experience gains. As a consequence, employers may wish to begin examining

opportunities and problems created under the new proposed regulations and determine whether it is in their interest to adopt any changes to their cafeteria plan before 2009.

Morgan Lewis attorneys have helped many employers design, document, and operate their cafeteria plans. We would be happy to help you examine the details of the repropoed regulations and determine whether it is appropriate to comply with parts of the repropoed regulations immediately or wait until the IRS releases its final cafeteria plan regulations.

We also anticipate issuing a longer LawFlash addressing additional details contained in the repropoed regulations.

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