Since Internal Revenue Code (“Code”) section 125 was enacted and cafeteria plans were first made available in 1978, the Internal Revenue Service has issued a grab bag of proposed regulations under Code section 125 but issued final regulations only for rules governing mid-year election changes (Treas. Reg. § 1.125-4) and coordination of family medical leave with cafeteria plan coverage (Treas. Reg. § 1.125-3). On August 6, 2007, the IRS withdrew all of the proposed regulations still outstanding and issued a new set of proposed regulations, providing comprehensive guidance on section 125, including definitions of qualified and nonqualified benefits; general rules on elections, flexible spending arrangements and substantiation of expenses; and nondiscrimination rules. These new proposed regulations consolidate rules included in the prior proposed regulations, as well as in a number of notices and revenue rulings. They retain many of the rules from the prior proposed regulations, but also include many new rules, such as detailed nondiscrimination requirements based on the rules for qualified retirement plans, requirements for the terms of the written plan document and the time the plan must be adopted, and several anti-abuse rules. The regulations are proposed to be effective January 1, 2009.

General Rules for a Cafeteria Plan and Permissible Benefits

The new proposed regulations define a cafeteria plan as a written plan that offers employees an election between at least one permitted taxable benefit and one qualified benefit and does not permit the deferral of compensation, except under limited circumstances. In a rule that has broad implications for benefits even outside the cafeteria plan context, the regulations specify that Code section 125 is the exclusive means to allow employees to choose between taxable and nontaxable benefits, and emphasize that any other choice between taxable and nontaxable benefits, even if made prior to the beginning of the year the taxable benefit is available, will result in the employee having income in the amount of the greatest taxable benefit available. For example, if an employer offers an employee a choice between (1) reimbursement of qualified moving expenses otherwise excludible from income, or (2) cash equal to the lesser
of a specified dollar amount or 75% of a quote by a specified mover, the employee will be taxable on the cash available despite electing the reimbursement.

The taxable benefits that may be offered under a cafeteria plan include:

- cash compensation through salary reduction or after-tax employee contributions;
- paid time off;
- severance;
- taxable property, such as stock; or
- benefits attributable to taxable employer contributions.

Qualified benefits are not taxable to employees and include:

- group-term life insurance up to $50,000;
- health coverage, including a health flexible spending arrangement (FSA) and payment or reimbursement of individual health insurance premiums;
- premiums for COBRA coverage;
- accidental death and dismemberment;
- long-term or short-term disability;
- dependent care;
- adoption assistance;
- elective deferrals to a 401(k) plan, but not a 403(b) arrangement;
- contributions to a Health Savings Account (HSA); or
- contributions for post-retirement group life coverage meeting certain conditions for employees of an educational organization.

The regulations also say that a cafeteria plan may permit employees to elect group-term life insurance in excess of $50,000. For this benefit, the regulations change the rules of Notice 89-110, providing that (1) the taxable amount to the employee is limited to the amount determined under the section 79 regulations, and (2) any salary reduction contributions and flex-credits for the coverage are excludible from the employee’s income. The regulations also permit employees to elect health coverage for individuals who are not dependents, such as former spouses or domestic partners, and say that the fair market value of the coverage for such a person is included in the employee’s income. Apparently, this rule means that the fair market value of the coverage is includible in income even if the employee does not pay anything additional for the coverage, for example, if the employee has previously elected family coverage for herself and her dependents. In addition, qualified benefits can be offered under the cafeteria plan even though they fail nondiscrimination requirements of, e.g., Code section 79 or section 105(h).
The following benefits cannot be offered under a cafeteria plan:

- scholarships;
- employer-provided meals and lodging;
- educational assistance;
- fringe benefits under Code section 132;
- long-term care insurance or services;
- group-term life insurance on the life of any person other than an employee; or
- contributions to a health reimbursement arrangement (HRA), medical savings account (MSA) or 403(b) arrangement.

The proposed regulations specify that a cafeteria plan must limit coverage to employees, but define employees to include leased employees and former employees, as long as the plan does not predominantly cover former employees. Partners, members of LLCs taxed as partnerships, sole proprietors, 2-percent shareholder employees of S Corporations, directors and independent contractors may not be covered under a cafeteria plan, although an individual who is both an employee and an independent contractor can be covered as an employee for that portion of his or her compensation.

The new regulations clarify that a plan is not a cafeteria plan unless an employee can opt out of coverage under a qualified benefit and receive cash or a taxable benefit. For example, if coverage under a health plan is mandatory for all employees or a subset of employees, such as employees who cannot certify that they have other health coverage, section 125 does not apply to their health coverage, even if they must pay a share of the cost for it through salary reduction contributions.

The proposed regulations continue to require that a cafeteria plan not permit the deferral of compensation, except to the limited extent described in the regulations. The exceptions include a number of rules for health plans, permitting features such as premium waiver for disability, reasonable lifetime limits on benefits, and a two-year lock-in for vision or dental coverage subject to certain conditions, as well as reimbursements for advance payments for orthodontia and for durable medical equipment. The restrictions include a rule that says reasonable premium rebates or policy dividends on any type of coverage are permitted only if paid before the end of the 12-month period following the plan year to which they relate, which may require changes in how some insurers process these amounts. Another new rule allows employers to apply salary reduction contributions made during the last month of a plan year to pay health plan premiums for the next month if the employer’s process is uniform and consistent.
Written Plan Requirements

The regulations propose detailed requirements that the written plan document must satisfy:

- The plan must be adopted in writing on or before the first day it is effective, and any amendment must be adopted in writing by the date it is effective;
- The terms of the plan must apply uniformly to all participants;
- The plan must include descriptions of the benefits available, rules for participation and elections, any grace period used, and a number of other specified terms;
- If the plan allows employees to elect paid time off, ordering rules require that any nonelective time off be used first and that these rules be included in the plan;
- The plan year must be specified in the plan and must be 12 months; and
- The plan year can be changed only for valid business reasons, and a short plan year is permitted only for a new plan or for another valid business purpose.

Failure to include any of the necessary terms in the written plan or to operate a plan in accordance with the written document or operational rules under the regulations, e.g., the use-it-or-lose-it rule for an FSA, results in a violation of section 125, with the result that all of the benefits become includible in income. Unlike qualified retirement plans, the rules include no opportunities for fixing errors in the written plan or in operation of the plan.

Rules for Initial Elections

The proposed regulations include several rules for initial elections under cafeteria plans. The existing rules for changes in elections under Treas. Reg. § 1.125-4 remain unchanged.

In general, an initial election must be made before the earlier of (1) the date cash compensation or any other taxable benefit is currently available (as defined in the regulations); or (2) the first day of the coverage period, which will usually be the plan year. Automatic elections, including evergreen elections that continue to apply a participant’s current year elections for the next year if he or she does not make an affirmative change, are permitted. A new rule allows a plan to provide that new employees have 30 days after hire to elect to participate in the plan. The new employee’s coverage may relate back to his initial date of hire, but any salary reduction must be taken from compensation that becomes currently available after the election is made. Other special rules apply for HSA contributions, which may be changed monthly or more often.
Requirements for FSAs

The proposed regulations confirm that a cafeteria plan may include a flexible spending account for reimbursement of (1) health, (2) dependent care, or (3) adoption expenses. These rules continue in effect many of the requirements under the prior proposed regulations, such as the use-it-or-lost-it rule, the limit on the maximum amount of reimbursement permitted, and the requirement that, for a health FSA, the maximum amount of reimbursement must be available at all times. The new rules say an amount is considered available at all times if reimbursements are processed monthly or are subject to a reasonable minimum, e.g., $50. Another new rule requires that any advance funding through salary reduction be refunded to a participant who terminates employment and participation in the FSA during the year.

The regulations emphasize that each FSA may be used solely to provide one type of benefit, including during any grace period. To preclude abuse of this rule and the use-it-or-lose it rule, the regulations indicate that an arrangement outside the plan to adjust an employee’s compensation or provide other benefits on the basis of forfeited FSA amounts is not permitted.

Specific rules for the application of “experience gains” or forfeitures from participants’ FSAs are included in the proposed regulations. These amounts may be:

- retained by the employer;
- used to defray administrative expenses;
- used to reduce salary reduction contributions for the next year on a “reasonable and uniform basis;” or
- returned to employees on a “reasonable and uniform basis,” consistent with detailed requirements included in the proposed rules.

Substantiation Rules

The regulations propose that a cafeteria plan may pay only expenses that are incurred during the applicable period of coverage and that are substantiated. These rules apply not only to an FSA, but to all qualified benefits, notably including any payment for individual health insurance or COBRA coverage. The period of coverage generally must be 12 months, but it need not be the same as the plan year. A special rule for dependent care would allow the continued reimbursement of dependent care expenses until the end of the year an employee terminates participation in the plan.

The required substantiation must be from a third-party who is independent of the employee and his or her spouse or dependents. The regulations include rules for substantiation of expenses paid through the use of a debit card, which generally follow the existing rules.
regulations also extend the ability to use a debit card to a dependent care FSA. Under this rule, the employee must pay the initial dependent care expense at the beginning of the year and obtain a statement including the date and amount of services incurred. If the expenses incurred for subsequent periods are no more than the initial expense, no further review is required, but an increase in expenses or a change in provider will require additional verification.

**Nondiscrimination Requirements**

The detailed nondiscrimination requirements in the new proposed regulations include rules regarding eligibility and availability of benefits and contributions. These rules preclude discrimination in favor of highly compensated individuals (HCI) for eligibility and discrimination in favor of highly compensated participants (HCP) for contributions and benefits, as well as imposing a special utilization limit for key employees as defined under Code section 416(i)(1).

For purposes of these rules:

- a highly compensated individual is any employee who, for the prior year (or the current year for a new employee), is an officer, 5% shareholder, or employee whose compensation exceeds the Code section 414(q)(1)(B) amount (currently $100,000) and is in the top-paid group, if elected by the employer;
- a highly compensated participant is an HCI who is eligible to participate in the plan;
- statutory nontaxable benefits are qualified benefits excludible from gross income plus group-term life insurance exceeding $50,000; and
- total benefits are qualified benefits plus taxable benefits.

The eligibility rule applies the qualified retirement plan nondiscriminatory classification test from the regulations under Code section 410(b). This is the test used in conjunction with the average benefits percentage test and for benefits, rights and features testing and certain tests for separate lines of business. The term HCI is substituted for the term “highly compensated employee” in performing this test. For the test, a plan may exclude employees who do not meet a minimum service requirement only if the plan requires 3 years of service for participation; however, employees with less than 3 years of service may be treated as if they are covered by a separate plan.

The benefit availability test requires that either:

- qualified benefits and total benefits; or
- employer contributions (including salary reduction contributions) for statutory nontaxable benefits and for total benefits do not discriminate in favor of HCPs.
For this test, all similarly situated employees must have the same opportunity to elect benefits, and HCPs must not disproportionately utilize or elect qualified benefits. Utilization is determined by comparing the aggregate qualified benefits elected by HCPs as a percentage of their aggregate compensation to the same percentage for non-highly compensated participants. Under a similar test for contributions, the aggregate contributions used by HCPs for statutory nontaxable benefits as a percentage of their aggregate compensation would be compared to the same percentage for nonhighly compensated participants. The new proposed regulations retain a special benefit availability rule for health plans provided under the prior proposed regulations, but specify it applies only to major medical, not dental coverage or a health FSA.

An additional test requires that the statutory nontaxable benefits for key employees not exceed 25% of the aggregate statutory nontaxable benefits for all employees. A premium-only plan satisfies this test if it satisfies the eligibility test.

All members of a controlled group are treated as a single employer for purposes of these tests. Employers may, but need not, aggregate two or more cafeteria plans for purposes of the tests, as long as the plans are not aggregated to manipulate the results. The proposed regulations further provide that:

- employer contributions to an HSA are subject to the nondiscrimination rules in these regulations, rather than the comparability rules of Code section 4980G;
- testing must be performed on the last day of the plan year, taking into account all non-excludable employees during the year;
- an anti-abuse rule prohibiting discrimination in favor of HCPs in operation also applies; and
- an HCP or key employee participating in a discriminatory plan must include in income the greatest value of taxable benefits he or she could have elected to receive.

As noted above, the new regulations are proposed to be effective January 1, 2009, though they may be relied upon in the interim. The new rules regarding the cost of life insurance includible in income are immediately effective, and Notice 89-110 is revoked as of August 6, 2007.
Please contact any of the following members of our Employee Benefits and Executive Compensation practice if you have any questions regarding this development:

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