



## New Proposed Cafeteria Regulations

On August 6, 2007, the Internal Revenue Service issued new proposed cafeteria plan regulations under section 125 of the Internal Revenue Code. The proposed regulations replace existing regulations dating back to 1984. The proposed regulations incorporate and restate prior proposed regulations and add much needed clarification. The new proposed regulations are expected to be effective for a plan's year starting on or after January 1, 2009, but can be relied upon immediately.

### Background

A cafeteria plan allows an employer to offer certain benefits to employees on a pre-tax basis. To qualify, an employee agrees to reduce compensation in exchange for benefits chosen prior to the start of the plan year. The proposed regulations reaffirm that a cafeteria plan must offer employees a choice between at least one permitted taxable benefit (typically cash) and at least one qualified nontaxable benefit.

### Nonqualified Benefits

A plan offering any nonqualified benefit is not a cafeteria plan. A cafeteria plan can not offer any of the following benefits:

- scholarships
- employer-provided meals and lodging
- educational assistance
- fringe benefits
- contributions to Archer Medical Savings Accounts
- group-term life insurance for spouse, child or dependent
- elective deferrals to tax-sheltered annuity plans or
- long-term care insurance

A plan offering only elections among nontaxable benefits or a plan offering only elections among taxable benefits is not a cafeteria plan. In order to keep the qualified benefits from being taxable to employees and ensure the plan is valid, employers will need to comply with the new proposed regulations.

Below are some cafeteria plan requirements that reflect several of the general changes of the new proposed cafeteria regulations.

### Written Plan

A cafeteria plan must be in writing and be operated in accordance with the written plan terms and must:

1. specifically describe all benefits
2. set forth eligibility rules, enrollment and election procedures
3. provide that all elections are irrevocable
4. state how employer contributions may be made
5. state the maximum amount of elective contributions
6. state the plan year
7. specify that only employees may participate
8. specify that the cafeteria plan year be for a 12-month period

If the cafeteria plan provides a flexible spending arrangement (FSA), it must also include provisions complying with the uniform coverage rule and the "use-it-or-lose-it" rule.

### Qualified Benefits

A cafeteria plan can only offer qualified benefits. Qualified benefits are generally benefits attributable to employer contributions that are not currently taxable to the employee by reason of an express provision of the Code and do not defer compensation. Qualified benefits include health and insurance benefits, such as medical, dental, vision, life insurance and disability plan. The new proposed regulations also recognize adoption assistance plans, certain deferred compensation benefits and health savings accounts (HSAs) as qualified benefits.

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## Elections

A cafeteria plan must require irrevocable elections annually, which must be made before the first day of the coverage period. Certain mid-year elections are permitted if they are included in the written cafeteria plan document. There is also a special rule that applies if the plan offers HSA contributions through salary reduction. Automatic elections are also permitted. Elections, revocations or changes in elections can be made electronically.

## Flexible Spending Arrangements (FSAs)

FSAs are designed to reimburse employees for incurred expenses of certain qualified benefits up to a designated amount. All benefits and contributions must be used by the end of the plan year (“use-or-lose-it” rule) or they must be forfeited. The required period of coverage for all FSAs is twelve months. The period of coverage and the plan year need not be the same. Non-elective employer contributions (or so-called “flex-credits”) can be used at the employee’s election for qualified benefits.

The new proposed regulations recognizes three types of FSAs:

1. dependent care assistance
2. adoption assistance
3. medical care reimbursements

## Experience Gains (Forfeitures)

Unused amounts are now referred as “experience gains.” The new rules retain the forfeiture allocation rules of prior guidance under which the employer sponsoring the cafeteria plan may:

- retain forfeitures
- use forfeitures to defray expenses of administering the plan
- allocate forfeitures among participating employees

## Substantiation of Claims

A cafeteria plan may only pay or reimburse an expense that is:

- properly substantiated
- incurred on or after enrolled in a particular qualified benefit
- incurred while covered under the particular qualified benefit

## Nondiscrimination

The cafeteria plan must not discriminate in favor of highly compensated individuals with respect to eligibility, contributions and benefits. Also, several key terms are now defined, including dependent, highly compensated individual or participant, officer, five percent shareholder, key employee and compensation. Testing under the new rules must be performed as of the last day of the plan year. The proposed regulations establish two safe harbors, under which a plan is deemed to be nondiscriminatory.

## Conclusion

Cafeteria Plans will soon be more formal, particularly in terms of documentation, substantiation and nondiscrimination.

Specific information regarding the proposed regulations can be found at:

[www.ustreas.gov/press/releases/reports/section125.pdf](http://www.ustreas.gov/press/releases/reports/section125.pdf).

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For complete copies of that issue, please contact us at (518) 374-5726 or via email at [pjg@lawrence-pearson.com](mailto:pjg@lawrence-pearson.com)

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