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White Paper

Ten Considerations For Section 125 Plans

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The IRS is revising the requirements of Section 125 plans. Here are 10 key points you'll need to review to ensure that your cafeteria plan is ready.

On Aug. 6, 2007, the Internal Revenue Service (IRS) effectively replaced the majority of existing regulations (both temporary and proposed) with respect to Section 125 plans, supplanting them with a new set of regulations that are to take effect for plan years beginning on or after Jan. 1, 2009. Two sets of regulations previously finalized (sections 1.125-3, FMLA, and 1.125-4, Permitted Election Changes) are not affected by this recent restatement. The new regulations affect all employers that allow employees to pay for benefits with pre-tax dollars. The new regulations also affect flexible spending accounts—both healthcare and dependent daycare accounts.

Section 125 plans, so called due to the section of the Internal Revenue Code (IRC), are employer-sponsored cafeteria plans. These plans allow an employer to offer certain benefits to employees on a "pre-tax" basis. To qualify, the employee agrees to reduce his or her compensation in exchange for benefits prior to when the benefits are effective. Cafeteria plans can be basic, such as a premium-only plan that allows for tax-free contributions to be made for the cost of health premiums. Some plans are far more complicated—those plans that utilize a "flexible" credit or dollar system that is used for the selection of a variety of benefit options. Regardless of the complexity of the plan, all employers who offer a Section 125 plan must comply with certain provisions in the establishment and operation of the plan in order to ensure the validity of the plan's tax-preferred status.

Basically, the IRS is performing needed maintenance on the Section 125 requirements. It is consolidating prior temporary and proposed regulations issued in 1984, 1986, 1989, 1997, and 2000 and all of the rules and updates issued over the past nine years. In doing so, it has taken this opportunity to clarify issues that have arisen as employer benefit offerings and administration practices have changed because of technology and other changes in the benefit arena.

The new regulations from the IRS should not require major changes in the design or administration of cafeteria plans. However, there are many clarifications and updates, which should prompt employers to audit their health and welfare benefit programs for compliance with the new regulations.

Milliman believes that the federal government intends to follow the implementation of the regulations with a higher level of enforcement. Specifically, we expect more diligence in auditing compliance after the new regulations go into effect in January 2009.

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The following items highlight what we believe are the 10 most significant features of the new regulations. We will also provide general recommendations for employers who need to review their cafeteria plans' compliance.

1. CLARIFIED DEFINITION OF ELIGIBILITY

Providing a comprehensive definition of eligibility is a priority for the IRS. While we already have instruction from the IRS that cafeteria plan participants are limited to employees and former employees, the revised regulations make it clear that cafeteria plans are designed to benefit the employee base, not key employees. As such, the regulations specify that common law employees, leased employees, and full-time life insurance salespeople are eligible; sole proprietors, partners, and directors (unless they have dual status

as employees) are not. Retired and laid-off employees may participate, but former employees cannot be the main beneficiaries of the plan.

The new regulations also make an important clarification: Spouses and dependents may receive benefits from the cafeteria plan as a result of their relationship with the employee, but they can't actually participate in the plan—choose options or purchase benefits—unless they happen to be employees themselves.

This section also clarifies the role of dependents, incorporating definitions that were established in the Working Families Tax Relief Act of 2004 (WFTA). These definitions utilize criteria measures that include the time the dependent lives with the employee, blood or marriage relations, working status of a dependent, and dependent age.

2. BENEFITS THAT CAN/MUST BE OFFERED

Cafeteria plans must offer only those benefits that are determined to be "qualified" benefits. Moreover, all cafeteria plans must offer the employee a choice between at least one qualified (or nontaxable) benefit and one taxable benefit.

The following are examples of benefits that can be included in a Section 125 plan:

Taxable benefits
- Cash/wages
- Any benefit purchased with after-tax employee contributions
- Paid time off and other paid leave
- Employer-paid benefits that are taxable to the employee (e.g., basic life)

Qualified benefits
- Medical
- Dental
- Life and accidental death and dismemberment
- Dependent-care assistance plans
- Flexible spending account (FSA)
- Short- and long-term disability
- Health savings account (HSA) contributions
- Adoption assistance

One of the key changes to note is that "cash" is defined as a qualified option. The regulations provide several examples of how and why this could be used as a qualified benefit. In one case, an employee fails to use all the elective time off available during the plan year under the cafeteria plan. In the other example, an employee already has another source of health coverage and elects not to participate in his/her employer's health benefit program. In both cases, the employee may choose to receive cash instead, which is a permitted benefit under the new regulations.

The register also defines specific nonqualified benefits that may not be offered in cafeteria plans:

- Scholarships
- Employer-provided meals and lodging
- Education assistance
- Fringe benefits
- Long-term care insurance or services
- Group term life insurance on the life of anyone other than the employee
- Health reimbursement arrangements (HRAs)
- Contributions to Archer MSAs
- Elective deferrals to a section 403(b) plan

HSA vs. HRA – What's the difference?

Health reimbursement accounts (HRAs) are the precursors of the consumer-driven health plan concept. The fund for this plan can only be employer-funded; therefore, there is no pre-tax contribution available to the employee.

Health savings accounts (HSAs) are the latest iteration of consumer-driven health plans. The employee can contribute pre-tax dollars to the HSA to cover eligible expenses that are subject to the deductible, as well as other qualified Section 213(d) expenses. The employer may also contribute to the account.

The regulations also provide a series of examples that illustrate the circumstances under which COBRA or individual health plan premiums may be paid through a cafeteria plan. Employers may want to review this provision carefully for administrative complexities before they decide to incorporate this feature into their plans.

3. CAFETERIA PLANS MUST BE IN WRITING

This is one of the simplest provisions in the code, yet it is also one of the most frequently overlooked. There are a surprising number of employers who have done all the work to put the benefits in place without having a document in place for the plan, formally adopting the plan, and communicating the provisions of the plan to the employee population. These failures can have harsh consequences should the plan become the subject of an audit.

The documentation requirements are comprehensive. The IRS has stated that, with respect to the written plan requirements: "The new proposed regulations require that the written plan specifically describe all benefits, set forth the rules for eligibility to participate and the procedure for making elections, provide that all elections are irrevocable … and state how employer contributions may be made under the plan (for example, salary reduction or non-elective employer contributions), the maximum amount of elective contributions, and the plan year" (Explanation of Provisions, Section 1.125-1, Written Plan).

In addition, there are specific documentation requirements for plans that include FSAs. Employers adopting the "grace period" provision (giving the employee an extra two months and 15 days to use the money set aside in the FSA) must document and formally adopt the provision as part of the plan prior to the start of the plan year.

One mitigating factor in the documentation process is the ability to "wrap" or "cross-reference" benefits contained in other written plans that the employer offers. For example, there may be benefits in a separate 401(k) plan or a dependent-care assistance program that are already documented separately. The cafeteria plan documentation can simply refer to those plans without having to describe the benefits again in full.

Once the plan is written and adopted, the plan provisions must be communicated to employees (via paper or electronically). Should the employer distribute information through electronic means, it must follow the provisions set forth by the Department of Labor to ensure receipt of the document.

4. ONE TABLE FOR CALCULATING IMPUTED INCOME FROM LIFE INSURANCE

The IRS counts as taxable income a percentage of the cost of group term life insurance coverage in excess of $50,000 (known as "imputed income"). This rule has not changed; however, the employer must now use Table 1 for calculating the tax. This is the same table the IRS uses for calculating the taxable consequence of the benefit. This change is effective immediately, not Jan. 1, 2009.

Cost Per $1,000 of Life Insurance for 1 Month

ATTAINED AGE (ON LAST DAY OF TAXABLE YEAR)	TABLE 1
UNDER 25	$.05
25-29	.06
30-34	.08
35-39	.09
40-44	.10
45-49	.15
50-54	.23
50-59	.43
60-64	.66
65-69	1.27
70 & OLDER	2.06

5. EMPLOYERS CAN ONLY CHANGE THE PLAN YEAR FOR A VALID BUSINESS PURPOSE

The regulations define the plan year as 12 consecutive months. The plan year can start on any day the employer chooses. But once established, it can only be changed for a valid business purpose.

The new proposed regulations provide examples such as launching a new plan in the middle of the year or changing to a new insurance carrier whose benefit year is different than the current plan year. In practice, we know that employers sometimes choose a calendar year or fiscal year plan year, only to find that the open enrollment period conflicts with other important business activities. Although it would be convenient to change the plan year, the regulations won't recognize that as valid.

The IRS provides an example of a valid business reason for changing a plan year. In an example contained in the regulations (Section 1.125-1(k)(d)(4), example 2), an employer has a calendar year cafeteria plan. In March, the employer contracts with a new health and insurance carrier to offer benefits starting July 1. In this situation, the employer would shorten the current plan year to end June 30 and start the new 12-month plan year effective July 1.

Another point to keep in mind is that specific benefits can have different coverage periods. For example, dependent care could be on a calendar-year schedule, while the premium-only plan (POP) and FSA plans correspond to a fiscal year. Employers need to determine in advance what works for them, administratively, and implement the plan accordingly.

6. MOST EMPLOYEE ELECTIONS ARE IRREVOCABLE

In general, employees can only elect the benefits they will receive during the open enrollment period prior to the new plan year or when they are newly eligible to participate. This section of the regulation references a previously finalized section—Section 1.125-4, Permitted Election Changes—that defines a permitted mid-year election change.

Though most elections are irrevocable, a cafeteria plan may allow employees to make changes during the plan year based on a change in family status or a pre-defined life event. Your plan document must specify if and how the plan treats mid-year changes.

Also, new hires have a 30-day window to change their elections; this grants them the equivalent of the open enrollment period that current employees enjoy, thus avoiding a discriminatory restriction that previously affected new hires.

An exception to the mid-year change limitation applies to HSAs. Employees can elect to change the amount they will put into an HSA at any time during the plan year. This rule recognizes that employees can't necessarily predict or control the timing of an expensive medical procedure. Because HSAs are tied to high-deductible medical policies, the employee may need to contribute $2,500 to fulfill the deductible on short notice. Employers need to incorporate this provision into their plan document when offering an HSA plan.

The new regulations also recognize the validity of electronic enrollments and elections, replacing the old paper document requirement. And employers can now establish automatic elections into pre-established default options. This is designed to help employers deal with employees who don't make their elections in a timely way.

7. A GRACE PERIOD EXTENDS ACCESS TO MONEY IN FSAS AN EXTRA TWO-AND-A-HALF MONTHS

Employee benefits professionals generally agree that the use-it-or-lose-it provision is a major drawback that limits employee acceptance of flexible spending accounts. The rules require employees to commit at the beginning of the plan year to the specific amount that they will contribute to their FSA. If the anticipated expenses fail to materialize, then the employees have lost their contributions.

The new proposed rules do not eliminate the use-it-or-lose-it provision; however, they formally sanction a previously enacted grace period, which allows employees to use any excess contributions during the first two-and-a-half months of the following plan year. This compromise solution helps employees but is potentially cumbersome for employers to administer.

Fortunately, the dependent-care assistance plan provisions allow a bit more flexibility to both employers and employees. Should an employee terminate employment during the plan year, he or she is eligible to receive reimbursement only for expenses that have already been incurred. However, any unused funds that are still in the plan could be used to pay for qualified dependent-care expenses even after the employee's termination.

The remainder of this section addresses a number of clarifications. Uniform coverage is still a requirement in the health FSA, just as it is in any other health plan. This means that the employee is eligible for the full amount of the benefit at any time during the plan year. For example, if an employee elects to contribute $3,000 to the health FSA via salary reductions spread equally over the 12-month period, he or she is entitled to compensation for any amount up to the full $3,000 in qualified medical expenses—even if they all occur at the very beginning of the plan year.

The IRS also has clarified the rules related to expenses for orthodontia. The new regulations permit employees to use money in an FSA to pay for advance deposits as well as for treatments that may not be performed until the following year. This eliminates the concern that such payments were a form of deferred compensation.

If you've been wondering whether, and how, an HSA can co-exist with an FSA, the new regulations address this issue. Because HSAs are only permissible with a high-deductible health plan (HDHP), the IRS defines two types of FSAs that are "HSA-compatible." The limited-purpose health FSA only pays for vision, dental, and preventive care. The post-deductible health FSA reimburses only expenses incurred after the HDHP deductible has been satisfied. Limited purpose and post-deductible benefits may also be offered in combination and still be HSA-compatible.

Finally, money forfeited by employees under the use-it-or-lose-it provision is called an "experience gain." Experience gains may be retained by the employer, used to reduce administrative expenses of the cafeteria plan, returned to employees, or used to reduce employees' required salary reduction amounts. The regulations describe procedures for allocating experience gains on a "reasonable and uniform basis."

8. NEW DEBIT CARD RULES FOR FSAS MAKE IT EASIER TO SUBSTANTIATE EXPENSES

Participants are responsible for proving that expenses they submit for reimbursement are qualified under the terms of the cafeteria plan. Ultimately, this means saving receipts that document each expenditure. The rule applies to all types of benefits, including dependent care, medical, dental, vision, etc.

However, it appears that the IRS's primary concern is regulating the use of debit cards. From the employer perspective, the governing philosophy has been "pay and chase." In other words, the employer trusts its employees enough to initially reimburse all claims with certain mechanisms in place to screen for questionable expenses. If such questions turn up, then the employer "chases" the participant, who must either provide suitable documentation or repay the expense.

The Section 125 regulations describe what employers must do to substantiate that charges are indeed qualified medical expenses. This includes having employees agree in writing to use the card only for qualified medical expenses, limiting the maximum amount available through the debit card to the amount elected for the FSA, and retaining the ability to deactivate the card if used improperly and requiring the employee to repay the non-qualified expenses.

Credit card companies are providing technology that simplifies the employer's job of substantiating expenses. A debit card can be limited by merchant category codes so that it will work only at the offices of physicians and dentists, vision care offices, hospitals, and pharmacies. The system can be programmed to recognize the amounts of the plan's prescription copays. The same is true for certain recurring medical expenses. And stores may have an inventory information approval system that automatically identifies approved and qualified Section 213(d) medical expenses.

Debit cards can also be used to reimburse dependent-care expenses, with the proviso that the participant can use the card only to seek reimbursement of services already incurred and paid out of pocket.

9. TIMING OF DISCRIMINATION TESTING

The discrimination testing rules are extremely important; failure to document compliance can result in the disqualification of the cafeteria plan. The good news is that there is only one major change to the discrimination testing rules. Under the new regulations, it is specified that the test must be performed on the last day of the plan year. By restricting testing to the last day of the year, the IRS effectively closes the door on some practices employers were using to adjust their percentages after the fact.

Many employers are under the impression that they only need to test participation in their dependent-care account. This is not correct. In fact, they are required to test all of the following:

- The cafeteria plan
- FSA medical plan
- Dependent-care plan
- Life insurance plan
- Self-insured medical plan

These are not dramatically different from one another; however, employers need to note slightly different definitions of key employees or safe harbor percentages for the different tests. The key point is to document all of the tests and be able to produce the results in case of an audit.

As an additional note, employers can no longer rely on the "sniff" test for the plan being available to all eligible em-

ployees, regardless of the enrollment. The employer must run an eligibility test based on who is enrolled as a means to determine if the enrollment is equitable across all groups of employees. In addition, the employer must perform a contributions and benefits test to determine if the employer contribution is equitably distributed once reasonable differences in the plan are taken into account.

10. THE MORE THINGS CHANGE, THE MORE THEY STAY THE SAME

Although there are changes in the regulations that govern Section 125 plans, the majority of the new regulations are a restatement of the guidance that has previously been in place and should already be followed in practice. Some of the prior practices that are being confirmed include:

- Allowing FSA participants to receive up to the full amount of their election at any time throughout the plan year
- Illustrating the scenarios under which changes in benefit elections can be made mid-year
- Particulars regarding the confirmation of eligibility of an expense for reimbursement, inclusive of the use of debit cards
- The exemption of FSAs from requirements that mandate the coverage periods are a match to the plan year
- Participation limitations in a health FSA to those employees enrolled in the employer's medical plan, while allowing the employer to implement a limitation on the qualified medical expenses that can be reimbursed through that health FSA
- The provisions regarding the usage of those funds that the employer collects because of the "use-it-or-lose-it" provisions of the FSA
- When and how to allow participants to change their HSA contribution elections

WHAT TO DO NEXT

The new proposed regulations take effect for plan years beginning on or after Jan. 1, 2009. This gives employers more than a year to get ready. However, because all prior proposed and temporary regulations have been revoked, employers should rely on the new set of regulations to operate their plan.

Employers who have been following the updates to the regulations over the years will find they have very little to do at this point, but an audit of their cafeteria plan should reveal any fine-tuning that is needed.

Other employers may find that they have fundamental gaps. We know from experience that not all employers have properly documented their cafeteria plan in writing. Also, failure to perform all of the required non-discrimination tests or to properly substantiate reimbursement requests in dependent-care programs are two areas where plans may be out of compliance.

If an employer is audited, there could be serious repercussions. For example, if a cafeteria plan is disqualified, the contributions made under that plan (by both employer and employee) could be determined to be taxable income. The employer then has to reissue W-2s for every participant, possibly for multiple years, and each employee can be faced with a large tax bill.

We understand that the IRS is training staff in the details of the new proposed regulations for cafeteria plans. The logical assumption is that it intends to audit compliance with the new regulations in 2009 and thereafter.

That's why we urge employers to take steps right away to determine the status of their Section 125 plans and correct any deficiencies. Milliman's experts can advise you how to bring your cafeteria plan up to date as quickly and efficiently as possible.

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