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MORE RULES FOR SECTION 125 CAFETERIA PLANS: SOME HELP AND SOME HURT

Debbie L. Blackwell* and Michael H. Taggart† ‡

I. INTRODUCTION

With the issuance of the proposed regulations under section 89,[1] the Internal Revenue Service (IRS) has taken the opportunity to issue additional guidelines regarding "cafeteria plans" under section 125.[2] The new section 125 regulation contains some surprises and some additional rules which may lessen the attractiveness of health care spending accounts. However, overall it represents a positive step in the development of flexible compensation. The issues addressed in the regulation include:

1. long needed guidance as to the benefits which may be provided under a cafeteria plan,
2. significant new rules concerning the operation of flexible spending accounts (FSA's) which, in combination with the application of the proposed section 89 rules, may reduce the attractiveness of spending accounts,
3. new guidance on the circumstances under which employees may change or revoke their elections due to changes in family status and other events,

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1. I.R.C. § 89 (1986). All section references in this article are to the Internal Revenue Code of 1986 (the Code or I.R.C.) unless otherwise indicated.

2. The new regulations were issued in proposed form at Proposed Treasury Regulations § 1.125-2, 54 Fed. Reg. 9460 (1989). The new proposed regulations under § 125 of the Code supersede the previously proposed § 125 regulations only to the extent that they are inconsistent. Prop. Treas. Reg. § 1.125-1, Q&A-30, 54 Fed. Reg. 9460, 9500 (1989). Although the regulations are issued in proposed form, taxpayers are entitled to rely on the proposed regulations until issuance of final regulations. Prop. Treas. Reg. § 1.125-2, 54 Fed. Reg. 9460, 9467 (1989). If some aspects of the final regulations are more restrictive, those rules will be applied on a prospective basis. *Id.*

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4. a rule which allows cafeteria plans to pay employees for unused vacation benefits,
5. guidance concerning the inclusion of section 401(k) plans in cafeteria plans.

In a separate regulation, the IRS issued new guidance concerning section 125(b)(1) which prohibits discrimination under a cafeteria plan in favor of highly compensated employees.[3] This guidance provides objective standards for determining whether cafeteria plan eligibility provisions are discriminatory.

II. Permissible Benefits

The section 125 regulation addresses some previously gray areas concerning the benefits which may be provided through a cafeteria plan. Section 125 provides that a cafeteria plan may include only "qualified benefits" and cash.[4] The regulations confirm that qualified benefits are those which: (1) are excludable from an employee's gross income due to a specific provision of the Code, and (2) do not operate to defer the receipt of compensation to any future year.[5] The only exception to the prohibition of deferred compensation in a cafeteria plan relates to amounts deferred under a qualified section 401(k) or similar plan.[6] Section 125(e)(2) provides that a group term life insurance benefit in excess of $50,000 is a qualified benefit even though it is includable in the recipient employee's gross income.

The regulation specifically addresses the treatment of certain benefits, the status of which has been uncertain until now. Accidental death

3. New guidance on the nondiscriminatory classification requirement, or "fair cross section" test, of Code § 125(b)(1) is provided in a proposed regulation issued under Code § 410(b). Prop. Treas. Reg. § 1.410(b)-4, 54 Fed. Reg. 21,437, 21,444 (1989). This regulation provides guidance on the minimum coverage rules as amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. The nondiscriminatory classification test set forth in Code § 410(b)(2)(A)(i) applies under numerous other Code provisions affecting employee benefit plans, including § 125. In the preamble to the proposed § 410(b) regulation, the IRS indicates that the nondiscriminatory classification test as set forth in Proposed Treasury Regulation § 1.410(b)-4 will be applied under §§ 120(c)(3), 125(b)(1), 127(b)(3), and 129(d)(2) (and presumably § 505(b)(1)(A)) but not §§ 89(g)(5) or 410(b)(5)(B) which relate to testing separate lines of business. Prop. Treas. Reg. § 1.410(b), 54 Fed. Reg. 21,437, 21,439 (1989). As with the proposed regulation under § 125, taxpayers may rely on the proposed § 410(b) regulation until final regulations are issued. *Id.* § 1.410 at 21,444.

4. I.R.C. § 125(c)(1)(B); Prop. Treas. Reg. § 1.125-2, Q&A-3, 54 Fed. Reg. 9460, 9500 (1989).

5. Prop. Treas. Reg. § 1.125-2, Q&A-4, Q&A-5(b), 54 Fed. Reg. 9460, 9500-01 (1989). Accident and health coverage, group term life insurance coverage, and dependent care assistance benefits will constitute qualified benefits even if includable in an employee's gross income by §§ 89 and 129(d), or any other applicable nondiscrimination requirement. *Id.* Q&A-4(a)(iii) at 9500.

6. I.R.C. § 125(c)(2)(B); Prop. Treas. Reg. § 1.125-2, Q&A-4(c), 54 Fed. Reg. 9460 (1989).

and dismemberment (AD&D) benefits may be included as pre-tax options under a cafeteria plan.[7] On the other hand, long-term care policies (with cash values) and permanent life insurance (such as group universal life plans) are specifically identified as benefits which operate to defer compensation and hence are not includable under a cafeteria plan.[8] Further, for plan years beginning after 1989, insurance premiums for other group or individual health plans are not eligible benefits under an FSA which typically is part of a cafeteria plan.[9]

The regulation provides that benefits which are offered under a cafeteria plan on a taxable basis (for example, long-term disability benefits provided on an after-tax basis) may be treated as an election by a participant to receive cash.[10] As a result of this provision, employers may include taxable benefits, such as dependent life insurance, in their cafeteria plans provided employees purchase such benefits on an after-tax basis. The new regulation also clarifies that a benefit is considered a permissible "cash" benefit if the employer pays for the benefit directly and treats the employee as having received the contribution in cash.[11]

Certain benefits may not be included in a cafeteria plan under any

7. The proposed regulations under § 89 provide that AD&D coverage is an accident and health benefit which qualifies for the income exclusion of § 106. Prop. Treas. Reg. § 1.89(a)-1, Q&A-1(f)(1)(ii), 54 Fed. Reg. 9460, 9470 (1989). This provision of the § 89 regulations is particularly good news for employers. Prior to this guidance, a great deal of uncertainty surrounded the tax treatment of the death portion of an AD&D benefit. The death benefit under an AD&D benefit does not provide a "general" death benefit required for tax-favored treatment under § 79. Treasury Regulation § 1.79-1(f)(3) refers to § 106, accident and health plans, for the tax treatment of accidental death benefits. Sections 105 and 106 and the regulations thereunder encompass medical, disability, and dismemberment benefits, but not accidental death benefits explicitly. *See* Treas. Reg. § 1.106-1; I.R.C. § 105. However, this regulatory position was anticipated in two private letter rulings. Priv. Ltr. Rul. 88-01-015 (Oct. 8, 1987); Priv. Ltr. Rul. 87-46-024 (Aug. 14, 1987).

8. Prop. Treas. Reg. § 1.125-2, Q&A-5(a), 54 Fed. Reg. 9460, 9501 (1989).

9. *Id.* Q&A-7(b)(4) at 9503-04. The common practice of allowing participants to pay for employee contributions required by a spouse's employer through a health FSA is not allowed for plan years commencing after December 31, 1989. *Id*; *see also* Prop. Treas. Reg. § 1.125-2, Q&A-1, 54 Fed. Reg. 9460, 9500 (1989). This new rule does not prohibit the payment of accident and health plan premiums directly (rather than from a health FSA) through salary reduction. Prop. Treas. Reg. § 1.125-2, Q&A-7(b)(4), 54 Fed. Reg. 9460, 9503-04 (1989). However, an employer may only be willing to allow such salary reduction for a coverage it sponsors or arranges rather than for coverages sponsored by another employer (*e.g.*, an employee's spouse's coverage). In addition, an employer must verify that the salary reduction contribution is for current (rather than deferred) coverage and that the contribution is actually used to purchase the coverage. *Id.* Q&A-5(a) at 9501; Rev. Rul. 61-146, 1961-2 C.B. 25. *See also* Rev. Rul. 75-241, 1975-1 C.B. 316; Rev. Rul. 57-33, 1957-1 C.B. 303 (regarding the consequences of an employer's failure to verify actual payment of premiums by an employee for coverage).

10. Prop. Treas. Reg. § 1.125-2, Q&A-4(b), 54 Fed. Reg. 9460, 9501(1989).

11. *Id.* Using this approach, an employer must report the contribution as taxable compensation for the employee and withhold from the employee's cash compensation the applicable income taxes and employment (*e.g.*, FICA) taxes.

circumstances.[12] If the benefit is of a type described in section 117[13] or section 132,[14] it may not be included in a cafeteria plan, either on a pretax or after-tax basis.

III. New Flexible Spending Account Rules

The new section 125 regulation contains several important new rules governing the operation of health and dependent care FSA's.[15] The regulation and the following discussion outline the new FSA rules primarily in the context of health FSA's. However, the regulation indicates that "analogous" rules apply to dependent care FSA's with the exception of the uniform coverage rule.[16] The rules apply to FSA's for plan years commencing after December 31, 1989.[17]

A. *The Uniform Coverage Rule*

1. In General

After flexible spending accounts became popular in the early 1980's, the IRS took the position that a health FSA could be included in a cafeteria plan only if it was an "accident and health plan" under sections 105 and 106.[18] According to the IRS, an accident and health plan must exhibit the risk-shifting and risk-distribution characteristics of an insurance program, regardless of whether the benefits are provided through an insurance contract or on a self-funded basis.[19] This view of

12. I.R.C. § 125(e)(1); Prop. Treas. Reg. § 1.125-2, Q&A-4(d), 54 Fed. Reg. 9460, 9501 (1989).

13. I.R.C. § 117 (providing an exclusion from gross income for certain qualified scholarships).

14. I.R.C. § 132 (providing an exclusion from gross income for certain fringe benefits which include no-additional-cost services, qualified employee discounts, working condition fringe benefits, and de minimus fringe benefits).

15. An FSA is defined as a benefit program that provides reimbursement for specified, incurred expenses and which includes a reimbursement maximum which is not "substantially in excess" of the total premium. Prop. Treas. Reg. § 1.125-2, Q&A-7(c), 54 Fed. Reg. 9460, 9502-03 (1989). For example, a medical reimbursement plan which provides a maximum reimbursement of $1,200 based on a $100 monthly premium is an FSA because the maximum reimbursement ($1,200) is not substantially in excess of the total annual premium ($1,200). The regulation indicates that a reimbursement maximum is not substantially in excess of the total premium if the maximum is less than 500% of the total premium. *Id.* The total premium includes the employee's and the employer's (if any) portion of the premium. *Id.* The definition of an FSA could encompass a typical indemnity plan with a low reimbursement maximum, such as a dental or vision plan. Of course, most of these plans currently satisfy the new FSA rules which are based on an insurance model. Interestingly, the new FSA rules purport to apply to health FSA's regardless of whether the FSA is offered under a cafeteria plan subject to § 125. *Id.* Q&A-7(a) at 9502-03.

16. *Id.* Q&A-7(b)(8) at 9504.

17. *Id.* Q&A-1, Q&A-7(d) at 9500, 9504.

18. Prop. Treas. Reg. § 1.125-1, Q&A-17, 49 Fed. Reg. 19,321, 19,326-27 (1984); Treas. Reg. § 1.105-5.

19. Prop. Treas. Reg. § 1.125-1, Q&A-17, 49 Fed. Reg. 19,321, 19,326-27 (1984); Treas. Reg.

spending accounts as a form of health insurance led first to the "use it or lose it" rule.[20] Under the "use it or lose it" rule, employee contributions to FSA's are treated as "premiums" which purchase coverage under the plan (the FSA) for the plan year. Employers were (and are) not allowed to return such "premiums" to the participant even if the premiums were not used to reimburse covered expenses.[21] The "premium" or "use it or lose it" concept implied that an employee was purchasing "insurance" for health or dependent care expenses through the FSA.

With the issuance of the new regulation, the IRS has further explained its position that a health FSA is simply a health plan providing 100% reimbursement of incurred expenses up to a maximum benefit amount elected by the participant.[22] Under the new "uniform coverage rule," a health FSA must make the full annual benefit available throughout the coverage period for reimbursement of incurred expenses.[23] The benefit payable to a participant cannot be limited to the amount contributed to the FSA as of the date a claim for reimbursement is filed.[24] The uniform coverage rule, however, does not apply to dependent care FSA's.[25]

The employer sponsoring the FSA will now be at risk to the extent that the incurred expenses exceed the amount contributed by the participant at the time the reimbursement claim is filed. With respect to participants who do not terminate employment during the year, the only difference to the employer will be the cash flow during the year. The new rules will tend to accelerate the employer's cash flow since there will no longer be "pending" expenses (expenses which exceed the amount contributed by the participant) under the FSA's. Instead, all validly incurred expenses up to the elected FSA coverage limit must be paid when a claim is submitted for reimbursement.[26]

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§ 1.105-5. This position is reiterated in the new regulation. Prop. Treas. Reg. § 1.125-2, Q&A-7(a), 54 Fed. Reg. 9460, 9502-03 (1989).

20. Prop. Treas. Reg. § 1.125-2, Q&A-7(a), 54 Fed. Reg. 9460, 9502-03 (1989). *See also* Prop. Treas. Reg. § 1.125-1, Q&A-18, 49 Fed. Reg. 19,321, 19,327-28 (1984) (regarding dependent care plans).

21. Prop. Treas. Reg. § 1.125-2, Q&A-7(a), 54 Fed. Reg. 9460, 9502-03 (1989).

22. *Id.* Q&A-7(a), (b)(1).

23. *Id.* Q&A-7(b)(2) at 9503. Reimbursement is available throughout the period if claims are paid monthly subject to a reasonable minimum amount, such as $50. *Id.* Thus, an employer may not prevent cash flow losses through redesign of claims procedures.

24. This limitation is very common in the design of FSA's prior to the application of the uniform coverage rule.

25. Prop. Treas. Reg. § 1.125-2, Q&A-7(b)(8), 54 Fed. Reg. 9460, 9504 (1989).

26. *See supra* note 23.

Employers reviewing the impact of these rules may conclude initially that the rules effectively eliminate the attractiveness of health FSA's. On closer examination, however, the employer's potential cost of operating health FSA's under the new rules is not so great as it may at first seem. At most, employers will be at risk under properly designed health FSA's only for the difference between the amount the employee has contributed to date and the maximum benefit elected under the FSA. Employees who terminate during the year will have the opportunity to receive more from the FSA than they contributed to it. Generally, the terminated employees who will profit from the uniform coverage rule are those who elected a high FSA limit, incurred a large, eligible health care expense early in the year, and then terminated soon thereafter. In addition, those who terminate early in the year may take advantage of the uniform coverage rule by electing COBRA as discussed below. The risk to the employer should, in most instances, be fairly small. Some employers have operated their health FSA's under the uniform coverage approach for several years with favorable results. They typically have had net experience gains from forfeitures exceeding the amounts lost due to using a uniform coverage approach.

2. COBRA and the Uniform Coverage Rule

Prior to the imposition of the uniform coverage rule, many employers allowed former employees to obtain health FSA reimbursements after separation from service even though the employee no longer contributed to the FSA. Reimbursements were limited to the remaining balance in the employee's account at termination.[27] This design was thought to discourage elections of health FSA participation (and reduce the related administrative headaches) by former employees pursuant to the continuation coverage rules enacted by the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA).[28] This approach generally will not be allowed after 1989 because of the uniform coverage rule for FSA's.[29]

27. This approach was considered reasonable, but balanced somewhat in favor of employees due to the "use it or lose it" rule.

28. Pub. L. No. 99-272, 100 Stat. 82 (1985).

29. Presumably, the cafeteria plan could provide that further premium payments are waived for the remainder of the plan year following a separation from service. However, the former employee would be entitled to elect FSA coverage for the following plan year under COBRA, and the employer would have given up the opportunity to collect the applicable premium for the remainder of the plan year of employment termination. *See* I.R.C. § 4980B(f)(2)(A); Prop. Treas. Reg. § 1.162-26, Q&A-30(c), 52 Fed. Reg. 22,716, 22,768 (1987).

Under the uniform coverage rule, employees must purchase health FSA "coverage" in order to receive reimbursement. If premiums are not paid, then coverage ceases. If premiums are paid, then the full annual coverage amount elected is available for reimbursement. Thus employees who separate from service before they have incurred claims equal to or greater than the amount paid in premiums to the FSA coverage should want to elect COBRA coverage under the FSA. Such individuals should pay for COBRA coverage for a period[30] which is long enough for them to incur additional health care expenses up to the FSA coverage maximum.[31] Adverse experience under the FSA due to COBRA should be fairly rare. First, employees will have to be fairly knowledgeable about their FSA and about COBRA in order to take advantage of this situation.[32] Second, an individual must be entitled to COBRA coverage (*e.g.*, no other group coverage) and must be willing to pay the monthly premium, even if unemployed. Finally, the individual must incur an eligible expense (and probably be required to pay the expense) prior to obtaining reimbursement. Many COBRA beneficiaries will be unable to afford this process.

Most employers probably will not experience significant problems with this kind of adverse selection against the FSA program. However, an employer considering the implementation or continuation of a health FSA should review the rate of its employee turnover in order to evaluate the potential impact to its program.

B. *Claim Substantiation Rules*

The new regulation provides very specific guidance concerning the manner in which claims for FSA reimbursements must be administered.[33] An FSA may provide reimbursement only if the participant provides the following information:

30. Under COBRA, individuals who elect to continue coverage must be allowed to pay the applicable premium on a monthly basis, even if active employees pay the premium on a different basis. I.R.C. § 4980B(f)(2)(C).

31. In addition, former employees who have COBRA coverage as a result of electing continued medical or dental coverage may, during a subsequent open enrollment, elect FSA coverage for the following plan year and then pay monthly premiums only long enough to incur claims equal to the maximum FSA coverage.

32. Employers are required to advise individuals who are eligible for COBRA coverage of their rights under COBRA, including their right to continue coverage under the health FSA. I.R.C. § 4980B(f)(6). However, an employer is not required to explain the manner in which the health FSA coverage may be manipulated under COBRA.

33. Prop. Treas. Reg. § 1.125-2, Q&A-7(b)(5), 54 Fed. Reg. 9460, 9504 (1989).

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1. a written statement from an independent third party (*e.g.*, the physician or day care center) indicating (a) the expense has been incurred,[34] and (b) the amount of the expense, and
2. a written statement from the participant that the health expense has not been reimbursed or is not reimbursable under other coverage (or that the dependent care expense is an eligible expense under the terms of the plan).[35]

These new requirements are primarily aimed at lax FSA administration and employer "loans" that effectively enabled participants to avoid the "use it or lose it" rule.[36] However, FSA claims administration forms and procedures thought to be sufficient under prior rules should be carefully reviewed to assure compliance. Expenses for which a statement from an independent third party cannot be obtained, such as use of a personal car for transportation to health care, should be excluded from coverage under the FSA. Further, FSA claims procedures should state that reimbursements are provided only for incurred expenses (*i.e.*, services rendered) and not for prepaid expenses. Prepayment of expenses is common for child care and orthodontic treatment.[37]

C. *FSA Experience Gains*

The proposed regulation confirms that an employer may use forfeited FSA contributions to reduce required participant contributions for the following plan year.[38] In addition, the regulation allows a return of such contributions to FSA participants as a "premium refund."[39] An experience gain is the excess of premiums paid (plus any income thereon) over total claim reimbursements plus reasonable administrative costs.[40]

34. A medical expense is "incurred" when the medical care is provided and not when the participant is formally billed or pays the bill. *Id.* Q&A-7(b)(6).

35. *Id.* Q&A-7(b)(5).

36. The regulation indicates that special scrutiny will be given to substantiation of claims in situations where an employer-to-employee loan is related to the employee's FSA premiums or the employee's actual or expected claims. *Id.* Such loans, if made at below-market interest rates, could result in additional income tax consequences for the employer and the employee. *See* I.R.C. § 7872.

37. Many employers currently provide "reimbursement" of dependent care expenses in advance of the provision of dependent care services because employees typically must pay for dependent care services in advance. A literal interpretation of the regulation indicates that this practice may have to change.

38. Prop. Treas. Reg. § 1.125-2, Q&A-7(b)(7), 54 Fed. Reg. 9460, 9504 (1989).

39. *Id.*

40. Premiums paid to an FSA include employer contributions. *Id.* Thus, if the employer pays the administrative costs of the FSA, such payment could be included as a premium payment with a net effect of zero on the experience gain calculation. Some FSA's include administrative costs in the participant's required premium which is not unlike insured health plans which provide for employee contributions based on the total insurance premium (including administrative costs). The proposed regulation appears to recognize that it is appropriate for administrative costs to constitute part of the

However, a premium reduction or a refund may not be allocated to a participant in a manner which relates directly or indirectly to the individual claims experience of such participant.[41] Such an allocation would result in avoidance of the "use it or lose it" rule.

D. *Annual Coverage Paid*

Elections for coverage provided under an FSA generally must be for a period of twelve months.[42] The coverage period may be less than twelve months only if it is equal to a short first plan year or to a short plan year resulting from a change of plan year.[43] The new regulation is more rigid than prior guidance in establishing a required period of twelve months for FSA coverage. The new regulation also clearly states the situations in which a shorter coverage period is permissible. The circumstances under which a cafeteria plan participant may change an FSA coverage election during such prescribed periods of coverage are discussed below.[44]

E. *Effect of Section 89 on Flexible Spending Accounts*

If section 89 remains substantially unchanged,[45] an unexpected provision of the section 89 proposed regulations would have a substantial

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FSA premium. Prior to issuance of this regulation, practitioners have been concerned that administrative costs are not a permissible expenditure of an FSA under Code § 105(b). Further, in some cases the administrative fees relative to the FSA coverage maximum could be unreasonable, giving rise to questions under the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829, as to whether the plan is operated for the exclusive benefit of employees and the plan assets, if any, have been prudently expended. *See generally* ERISA § 404 (codified at 29 U.S.C. § 1104 (1982)). The proposed regulation appears to suggest that the concern with respect to Code § 105(b) is not justified. *See* Prop. Treas. Reg. § 1.125-2, Q&A-7(b)(1), 54 Fed. Reg. 9460, 9503 (1989). The possible problems under ERISA should not arise for health FSA's unless the administrative fees are unreasonable. ERISA issues should not arise for a dependent care FSA which, in the views of the Department of Labor, does not constitute a plan covered by ERISA. Op. Dep't of Labor, 88-10A (Aug. 12, 1988) (LEXIS, ERISA).

41. Prop. Treas. Reg. § 1.125-2, Q&A-7(b)(7), 54 Fed. Reg. 9460, 9504 (1989).

42. *Id.* Q&A-7(b)(3) at 9503. In addition, a health FSA which is part of a cafeteria plan may not operate in a manner that enables participants to receive coverage only for periods in which they expect to incur medical expenses if such periods are less than a year. *Id.* Q&A-7(a) at 9502-03. *See also* Prop. Treas. Reg. § 1.125-1, Q&A-17, Q&A-18, 49 Fed. Reg. 19,321, 19,326-28 (1984) (regarding dependent care FSA's).

43. Prop. Treas. Reg. § 1.125-2, Q&A-7(b)(3), 54 Fed. Reg. 9460, 9503 (1989).

44. *See infra* notes 81-85 regarding special considerations for mid-year FSA election changes.

45. During the preparation of this article, the U.S. House of Representatives has voted to repeal § 89. H.R. 3299, 101st Cong., 1st Sess. This proposed repeal may be dropped from the 1989 budget legislation. However, repeal of § 89 appears to be imminent. Nondiscrimination rules of §§ 125 and 105(h) (relating to self-insured plans) in effect prior to 1989 are likely to be reinstated in the repeal process. Reinstatement of pre-TRA nondiscrimination rules may mean that tax advantages of health FSA's will remain uncertain for highly compensated employees. The negative view of health

impact on the health FSA's of highly compensated employees for plan years beginning after December 31, 1989. Under the regulations, non-highly compensated employees are generally treated as ineligible for a non-core health benefit attributable to salary reduction contributions that are greater than $2,000.[46] This new rule would effectively limit the tax-favored treatment of non-core health benefits, such as FSA's and dental plans, for highly compensated employees to approximately $2,100.[47] Of course, this provision of the proposed section 89 regulations may never take effect if section 89 is substantially revised. However, proposals to simplify section 89 will have a similar effect on health FSA's for highly compensated employees. Thus, an employer should plan to view health FSA's in a cafeteria plan as primarily benefiting non-highly compensated employees because the tax-favored health FSA benefit for most highly compensated employees likely will be significantly curtailed.

IV. Mid-Year Election Changes

Participants in a cafeteria plan must elect benefits for an entire plan year and may not change those elections during the plan year except in certain circumstances.[48] Earlier guidelines concerning cafeteria plans allowed plans to provide for mid-year election changes due only to certain "changes in family status."[49] The new regulation provides for two types of mid-year election changes. One type is the re-election due to a change in family status. The regulation provides helpful guidance concerning events which are considered changes in family status.[50] The other type of election change involves circumstances generally beyond the employee's control and allows only for limited changes in participant elections.[51] When considering these rules for a cafeteria plan, a plan sponsor should keep in mind that such election change rules may, but need not, be provided in the plan. As discussed below, plan sponsors should take

FSA's held by the IRS could resurface in future cafeteria plan rules or in the application of the § 105(h) nondiscrimination rules for self-insured medical reimbursement plans.

46. Prop. Treas. Reg. § 1.89-1, Q&A-4(d)(2), 54 Fed. Reg. 9460, 9477 (1989).

47. The $2,000 limitation on deemed availability affects highly compensated employees under the 50% test set forth in § 89(d)(1)(B). The 50% test may be satisfied by aggregating "comparable plans" (*i.e.*, with value differentials of no more than 5%). I.R.C. § 89(g)(1)(B). A $2,000 benefit has a value that is at least 95% of a $2,105 benefit.

48. Prop. Treas. Reg. § 1.125-2, Q&A-6(a), 54 Fed. Reg. 9460, 9502 (1989); *see also* Prop. Treas. Reg. § 1.125-1, Q&A-15, 49 Fed. Reg. 19,321, 19,325 (1984).

49. Prop. Treas. Reg. § 1.125-1, Q&A-8, Q&A-15, 49 Fed. Reg. 19321, 19,324, 19,325 (1984).

50. Prop. Treas. Reg. § 1.125-2, Q&A-6(c), 54 Fed. Reg. 9460, 9502 (1989).

51. *Id.* Q&A-6(b), (d), (e).

particular care in designing election change provisions for health FSA's under the new rules.

A. *Changes in Family Status*

Participants in cafeteria plans generally may not change their benefit elections during a plan year unless they experience a change in family status as defined by Treasury regulations or other specified events. Employers sponsoring cafeteria plans have been struggling with the rather brief list of changes in family status provided in earlier guidelines.[52] The recently proposed regulation provides very helpful guidance in the form of an expanded list of events which constitute changes in family status.[53]

A 1984 proposed regulation listed examples of changes in family status which include marriage or divorce of the employee, death of the employee's spouse or a dependent, birth or adoption of a child, and termination of the spouse's employment.[54] The new regulation adds the following examples to the list of events which constitute changes in family status:

1. the commencement of employment of the employee's spouse,
2. a change from part-time to full-time employment status or vice versa by either the employee or the employee's spouse,
3. the taking of an unpaid leave of absence by either the employee or the employee's spouse, and
4. a significant change in the health coverage of the employee or spouse attributable to the spouse's employment.[55]

The new regulation also requires that a family status change resulting from the birth or adoption of a child relates to a child *of the employee*.[56] This new language in the regulation may eliminate the birth or adoption of a grandchild as a family status change unless the employee adopts the grandchild.[57]

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52. Prop. Treas. Reg. § 1.125-1, Q&A-8, 49 Fed. Reg. 19,321, 19,324 (1984).
53. Prop. Treas. Reg. § 1.125-2, Q&A-6(c), 54 Fed. Reg. 9460, 9502 (1989).
54. Prop. Treas. Reg. § 1.125-1, Q&A-8, 49 Fed. Reg. 19,321, 19,324 (1984).
55. Prop. Treas. Reg. § 1.125-2, Q&A-6(c), 54 Fed. Reg. 9460, 9502 (1989).
56. *Id.* (emphasis added). *Compare id. with* Prop. Treas. Reg. § 1.125-1, Q&A-8, 49 Fed. Reg. 19,321, 19,324 (1984).
57. An employee's grandchild can be a dependent of the employee within the meaning of Code § 152 for the purpose of the federal income tax personal exemption deduction and thereby qualify as an eligible dependent for certain cafeteria plan benefits if dependent eligibility is defined with reference to Code § 152. Many FSA's include this broad definition of "eligible dependent" in order to allow employees to take full advantage of the income tax rules. However, the introduction to the new regulation of the limiting language with respect to the birth or adoption of a child suggests that a change in family status may occur only with respect to an individual with whom the employee has an identifiable parent-child relationship.

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As with the previously issued regulation, the new regulation describes changes in family status in the form of examples rather than by an exhaustive list. Thus other events similar to those provided in the regulation may be treated as changes in family status as well. However, many employers may prefer to follow the conservative approach of allowing election changes due only to events listed in the regulation.

The new guidance on changes in family status recognizes that certain employment changes (for the employee or spouse) substantially affect the financial circumstances of an employee. Some of the new examples of changes in family status are not beyond the control or discretion of the employee or the employee's spouse. However, these events primarily relate to changes in employment status which would probably not be undertaken by an employee or an employee's spouse merely to create the opportunity for a change of election by the employee.

Considering the nature of the new guidance, the IRS should consider the transfer of an employee to a new location outside the employee's health maintenance organization (HMO) service area as a change in family status. Though the proposed regulation does not explicitly address the transfer of an employee, the transfer of an employee's spouse resulting in a move outside of an HMO service area would clearly constitute a change in family status.[58] An employee's transfer should not be any less of a "change in family status."

The new guidelines continue to require that election changes by employees be allowed only to the extent that they are "on account of and consistent with" the related change in family status.[59] The newly proposed regulation provides that an election change is "consistent with" a change in family status only if the election change is "necessary or appropriate" as a result of the change in family status.[60] Some employers, concerned about the lack of guidance on the meaning of "consistent with," construed this requirement to mean, in effect, "strictly necessary." For example, a conservative employer may only allow an employee who has "employee plus spouse" coverage to change to "employee plus spouse and child" coverage upon the birth of a child. However, an appropriate (rather than necessary) change could be from "employee plus spouse" coverage to "employee only" coverage if the spouse's employer

58. An election change is permitted when the health coverage of the employee or his spouse changes significantly due to the spouse's employment. Prop. Treas. Reg. § 1.125-2, Q&A-6(c), 54 Fed. Reg. 9460, 9502 (1989).

59. *Id.*

60. *Id.*

provides full family coverage at a lower cost.[61]

Employers should consider adding objective criteria to their cafeteria plans for determining whether an election change is "on account of and consistent with" a change in family status. The qualification rules of section 89(k) provide that the terms of a cafeteria plan must be legally enforceable.[62] A plan does not satisfy this requirement if the terms of the plan are applied in a discretionary fashion.[63] Despite being part of the regulatory scheme for cafeteria plans, the applicable standard for family status changes — "on account of and consistent with" — is rather vague and may result in subjective determinations. Guidelines or plan provisions identifying permissible election changes due to the various changes in family status should be established to satisfy the "legally enforceable" requirments of section 89(k).

B. *Other Election Changes*

In addition to the expanded list of events which constitute changes in family status, the new regulation provides guidance concerning other circumstances under which employees may make mid-year election changes.[64] These other events include:

1. separation from service by the employee,
2. cessation of required contributions by the employee,
3. health plan cost changes, and
4. health plan coverage changes.

If an employer wishes to take advantage of these new election rules, then the plan must specifically provide for such election changes.[65]

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61. Of course, an employer's administrative guidelines or election change forms should reflect a good faith effort to restrict family status change elections to those which are consistent — either necessary or appropriate — with the change in family status. Allowing "appropriate" election changes in addition to "necessary" changes may require a greater level of documentation at the point of the employee's election. For example, a certified statement from the employee indicating the appropriateness of the change may be advisable in order for the employer to demonstrate compliance on audit. The proposed regulations do not appear to require an employer to independently investigate the appropriateness of the employee's election.

62. I.R.C. §§ 125(c)(1), 89(k)(1)(B). The standards for satisfaction of this requirement are set forth in Prop. Treas. Reg. § 1.89(k)-1, Q&A-4, 54 Fed. Reg. 9460, 9492-93 (1989).

63. Prop. Treas. Reg. § 1.89(k)-1, Q&A-4(b)(1), 54 Fed. Reg. 9460, 9492-93 (1989).

64. *Id.* Q&A-6(b), (d), (e) at 9502.

65. *Id.* Q&A-6(a). A cafeteria plan may also provide, in connection with proposed § 89 rules, for a mid-year election of core health coverage by a non-highly compensated employee for himself or any of his dependents who lose core health coverage under another health plan. *Id.* This mid-year change is allowed under the § 125 rules because such changes must be allowed under an employer's core health plans if employees or their family members are disregarded for § 89 testing purposes due to having other core coverage. Prop. Treas. Reg. § 1.89(a), Q&A-3(c)(6), 54 Fed. Reg. 9460, 9474-75 (1989). Such change must be allowed under the § 89 rules without regard to the reason that the

1. Separation from Service

An employee who separates from service may be allowed to revoke his elections and terminate receipt of benefits for the remainder of the plan year.[66] However, if the employee returns to service, a new election by the returning employee must not be permitted for the remainder of the plan year.[67] Presumably, the rehired employee may not resume the coverage provided under previous elections. Such a resumption of a prior election probably constitutes a "new election," although the regulation is not clear on this point.[68]

Alternatively, the plan may provide that participation is automatically terminated as a result of separation from service.[69] With either approach, the employee may elect COBRA and continue health plan coverage for up to eighteen months after the date of employment termination. As a practical matter, the employer may not be able to collect the premiums or operate the plan in any more favorable manner if continued participation is allowed with a revocation option. Thus, continued participation after separation from service (subject to an option of the employee to revoke participation) does not appear to be a materially

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other core coverage ceased. This exception to the § 125 election rules is available only to the extent required to satisfy the § 89 rules.

66. Prop. Treas. Reg. § 1.125-2, Q&A-6(d), 54 Fed. Reg. 9460, 9502 (1989).

67. *Id.*

68. Paragraph (d) of Q&A-6 prohibits a rehired employee from making a "new benefit election" upon rehire during the same coverage period if the employee revoked his earlier election upon separation from service. *Id.* In this situation, it appears that "new benefit election" could be reasonably construed as either (1) an election that differs from the election in effect prior to separation from service, or (2) any election of participation upon rehire including a resumption of the election in effect prior to separation from service. The former construction prohibiting only different elections is more persuasive if the resumption of the prior election is automatic (*i.e.*, a condition of re-employment) rather than elective upon re-employment. However, paragraph (e) of Q&A-6 includes a similar prohibition of a "new benefit election" during a coverage period following a cessation of coverage due to a failure to pay premiums. *Id.* Q&A-6(e). In paragraph (e), a "new benefit election" is more reasonably construed as meaning "any election", including resumption of the election in effect prior to the failure to pay premium. The cafeteria plan election rules are designed to provide only limited exceptions to the requirement that cafeteria plan elections be made for an entire coverage period. *See id.* Q&A-6(a), 54 Fed. Reg. 9460, 9502 (1989). Interpreting paragraph (e) as precluding only a "different election" during the remainder of the coverage period would suggest that employees could stop and start coverage practically at will by revoking and recommencing a salary reduction agreement. The same terminology used in two similar paragraphs within a regulation should have the same meaning. However, construction of the phrase "new benefit election" to mean "any election" may be more restrictive than was intended for rehired employees under paragraph (d) since the prohibition of a "different election" would seem to sufficiently prevent manipulation of the election rules.

69. Upon rehire during the same plan year, the rehired employee could then commence participation in the cafeteria plan as a *new* employee. However, this approach may be perceived by the IRS as a tactic for avoiding the election change restrictions if the rehired employee is not required to serve any eligibility waiting period applicable to new employees.

better feature with respect to health plans offered through a cafeteria plan than automatically terminating the employee's participation and making available the COBRA option immediately.

A third design approach would be to require that employees agree to participate in the plan and make premium payments for a full coverage period regardless of their employment status throughout the plan year. With this approach, the employer would collect contributions for the remainder of the coverage period from the separating employee's last paycheck. Former employees could also contribute through subsequent payments from personal funds. If the former employee refused to pay, the employer would have a contract claim against the employee for the remaining contributions. This approach is discussed below in connection with the design of health FSA's under the uniform coverage rules. Such required annual participation elections may be most appropriate for health FSA's under the new rules. It may not be as appropriate for other types of benefits under a cafeteria plan because of insurance company requirements or general underwriting and administration considerations.[70]

2. Cessation of Required Contributions

A cafeteria plan may provide that benefit coverage will cease if the employee fails to make the required premium payments for the benefits elected.[71] However, no new elections may subsequently be made by such employee for the remainder of the plan year.[72] This new rule will enable employers to address more confidently a variety of situations. For example, the plan may provide that coverage is terminated for an employee whose paycheck for a particular pay period is insufficient to cover the required contributions and who does not pay the contribution with personal funds. This situation may arise for hourly-paid employees with low hours for a particular pay period.

The laws of some states prohibit or limit irrevocable payroll deduction authorizations. Coverage may be terminated for employees who exercise their rights under such laws and revoke their salary reduction agreements during a plan year. Employers may wish to explore whether

70. For example, many insurance policies require covered employees to be actively working a minimum number of hours per week (except for vacations or short illnesses) in order to receive coverage. Large employers can often negotiate changes in these requirements, but smaller employers typically cannot.

71. Prop. Treas. Reg. § 1.125-2, Q&A-6(e), 54 Fed. Reg. 9460, 9502 (1989).

72. *Id.*

ERISA preempts a state law of this type.[73]

3. Health Plan Cost Changes

If the cost of a health plan is increased or decreased by an insurance company or another independent, third-party provider of benefits, a cafeteria plan may provide for an automatic adjustment of employee contributions (pre-tax or after-tax) with respect to such benefits.[74] For example, if employees are required by the plan to contribute 25% of the cost of core health benefits, a mid-year cost increase by an insurance company or an HMO could trigger an automatic increase in the level of the employee contributions. The terms of the plan should provide a means for determining the extent to which contributions are increased. The increase (or decrease) in the cost of the plan must be the result of an action of an independent, third-party provider.[75] A cost increase implemented by an employer under a self-insured plan is not a permissible basis for a mid-year automatic adjustment of employee contributions.

The regulation further provides that if the cost is increased "significantly," then the plan may allow employees to either increase their premiums, or revoke their previous elections and select another health plan with "similar" coverage.[76] Consider, for example, an employer who offers a comprehensive indemnity plan and an HMO. The HMO significantly increases its premium during the plan year, resulting in a substantial increase in contributions for employees. The affected employees may elect either to increase their premiums to the new level required by the HMO, or to revoke their HMO election and elect to participate in the indemnity plan for the remainder of the plan year. The employees may not opt out of coverage for the remainder of the plan year.

73. If the state law "relates to" employee benefits plans and does not regulate insurance, banking, or securities, then it is, as a general rule, preempted by ERISA. Shaw v. Delta Air Lines, 463 U.S. 85 (1983). However, ERISA does not preempt generally applicable criminal statutes. ERISA, Pub. L. No. 93-406, 88 Stat. 829, § 514(b)(4) (codified at 29 U.S.C. § 1144(b)(4) (1982)). State wage laws often carry criminal penalties. For an analysis of the generally applicable criminal law standard, see Massachusetts v. Norash, 402 Mass. 287, 522 N.E.2d 409 (1988), *rev'd on other grounds*, __ U.S. __, 109 S.Ct. 1668 (1989); Commonwealth v. Frederico, 2 Employee Benefits Cas. (BNA) 2382 (1981). *See also* Upholsterer's Int'l Union Health & Welfare Fund v. Pontiac Furniture, Inc., 647 F. Supp. 1053 (C.D. Ill. 1986); National Metalcrafters v. McNeil, 602 F. Supp. 232 (E.D. Ill. 1985), *rev'd on other grounds*, 784 F.2d 817 (7th Cir. 1986).

74. Prop. Treas. Reg. § 1.125-2, Q&A-6(b)(1), 54 Fed. Reg. 9460, 9502 (1989).

75. *Id.* The regulation does not indicate any method of determining independence of a third party for this purpose. However, an employer is likely not independent of its self-insured health plan.

76. *Id.* The second sentence of Q&A-6(b)(1) does not literally require that the "significant" increase be the result of an action by an independent third party. However, the context suggests that this was intended.

The regulation does not provide any guidance on the magnitude of a cost increase required to be considered "significant." Also, no guidance is provided under the regulation as to what constitutes "similar" coverage.[77]

4. Health Plan Coverage Changes

If a third-party provider of benefits significantly curtails or ceases providing health coverage during a plan year, a cafeteria plan may provide that participants may re-elect other "similar" health coverage.[78] The curtailment or cessation of health coverage must be the result of an action of an independent, third-party provider of benefits as opposed to a self-insured employer.[79] Further, participants may only revoke their elections and re-elect other "similar" health coverage rather than electing to opt out of health coverage for the remainder of the plan year.[80]

This new provision will be particularly helpful in situations involving an insurance company or HMO insolvency. The regulation does not provide guidance concerning the determination of whether a "significant" curtailment has occurred. A situation of significant curtailment may arise where a substantial number of an HMO's contracting physicians have terminated their contracts with the HMO, thereby resulting in the HMO's failure to deliver a "significant" portion of the services it promised.

C. *Special Considerations for FSA Election Changes*

1. In General

Plan provisions governing mid-year election changes for health FSA's should be carefully reviewed by employers for plan years beginning after December 31, 1989. Changes in the mid-year election rules are essential to achieve the most efficient design and administration under the new rules. FSA's may include greater restrictions on mid-year election changes than other cafeteria plan benefits.

Under the new regulations, FSA elections may be changed during a plan year only on account of the following occurrences:

77. The proposed regulation provides that an employee may elect other coverage "under another health plan with similar coverage." *Id.* Presumably, this would include coverage through a spouse's employer if such coverage is similar.

78. *Id.* Q&A-6(b)(2).

79. *Id.*; *see also supra* note 75.

80. Prop. Treas. Reg. § 1.125-2, Q&A-6(b)(2), 54 Fed. Reg. 9460, 9502 (1989); *see also supra* note 77.

1. changes in family status,
2. separation from service, and
3. failure to make required contributions.[81]

Election changes are not allowed on account of changes in plan cost or coverage which are now allowed for health plans other than FSA's.

2. Changes in Family Status and the Uniform Coverage Rule

The uniform coverage rule introduces significant complications for the administration of health FSA's unless plan design changes are implemented. Most employers allow employees to make mid-year election changes for health FSA's due to changes in family status. If these plan election rules remain unchanged, an employee who experiences a change in family status may elect to reduce his level of FSA coverage and corresponding FSA premiums after he has received the maximum reimbursement under the FSA.

The proposed regulation does not provide any guidance concerning the manner in which the uniform coverage rule is applied when a mid-year election change is made due to a change in family status. Consider, for example, an employee who elects $1,200 of FSA coverage and pays a $100 monthly premium. In June, the employee is divorced and wishes to reduce his coverage to $800 effective July 1. The employee has had $1,200 of coverage for the first six months. The regulation is unclear as to what coverage or maximum reimbursement must be made available for the remainder of the year.

A reasonable approach is to provide that the coverage for the remaining six months of the coverage period is reduced to $800, taking into account any claims incurred during the first six months of coverage at the $1,200 maximum.[82] Under this approach, an employee who had already incurred $500 of covered claims prior to July 1 would be entitled to reimbursement of an additional $300 for claims incurred after July 1.

If downward elections are allowed, the employer must determine the proper premium amount to be charged. Again, the proposed regulation provides no guidance. In such a situation, the employer should not be required to calculate FSA premiums on the same basis that would have applied when the employee initially enrolled for the FSA coverage.

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81. Prop. Treas. Reg. § 1.125-2, Q&A-7(b)(3), 54 Fed. Reg. 9460, 9503 (1989).

82. A very unfavorable interpretation of the regulation would require that a *new* coverage period begin on July 1 with coverage of $800 available for the remaining six months of the coverage period without regard to whether the employee had already incurred $1,200 of claims under the coverage available for the first six months.

For example, the one-third reduction in coverage from $1,200 to $800 may result in only a 20% or 25% reduction in monthly premiums (*e.g.*, from $100 to $75). However, this limited premium reduction may be difficult to communicate to employees in connection with changes in family status.

The proposed regulations also fail to provide guidance for the treatment of an election to increase FSA coverage. However, no increase in risk of loss to the employer should arise given proper structuring of premiums. For example, consider an employee who elects $1,200 FSA coverage and then marries and wishes to increase his coverage to $1,800 effective July 1. As of July 1, the employer has collected $600 in premium and must collect $1,200 of premium over the remaining six months of the coverage period in order to support the $1,800 of coverage. The employer should increase the employee's premium for health FSA coverage from $100 per month to $200 per month so that over the course of the coverage period the employer will collect a full $1,800 of premium.

A cafeteria plan is not *required* to allow changes in the elections during a plan year due to changes in family status. Such mid-year election changes may be allowed only if the employer designs the plan to so provide. Employers may eliminate or substantially restrict change in family status elections for health FSA's under a cafeteria plan while allowing the full range of election changes for other benefits. As a result, employers may wish to consider adopting one or more of the following plan limitations to address this issue:

1. no mid-year election changes allowed for health FSA elections,
2. only mid-year *increases* (not decreases) in health FSA coverage allowed,
3. mid-year decreases (partial or full) allowed only on account of divorce or death of a spouse or child(ren),
4. limitations on coverage of expensive, discretionary health care services under the health FSA,
5. full payment of the FSA premium required early in the coverage period (*e.g.*, full payment of premiums spread over the first one to three months of the coverage period),
6. remaining unpaid premiums for the coverage period withheld from the last paycheck of each terminating employee.

The last two items above involve substantial employee relations and administrative problems. For many employers, the payroll department is the last to know of an employee's termination. Furthermore, withholding from the last paycheck may not be an option under state wage laws

even if the information concerning the terminating employee could be communicated to the payroll department and processed in time to affect the last paycheck. If withholding from the last paycheck is administratively feasible, such withholding should be clearly authorized in the employee's salary reduction agreement and must be applied to *all* participating employees, regardless of whether they incurred any expenses prior to termination.

An employer may also require the employee to agree to pay the full annual premium regardless of whether the employee continues his employment through the end of the coverage period. If withholding from the last paycheck is not an option, then the employer would have a contract claim against the terminating employee for the remaining unpaid premium. However, many employers will not wish to pursue these claims against former employees.

3. Separation from Service

As discussed above, a cafeteria plan may permit the employee to revoke an existing health FSA election and terminate coverage under the FSA if an employee separates from service.[83] On the other hand, the employee may continue coverage after separation from service (under COBRA or otherwise) by paying the required premium.[84] Continued "premium" payment or a plan provision waiving such premium payment upon separation from service are the only ways in which an employee may continue to receive reimbursement of expenses which are subsequently incurred. This treatment of FSA participation is based on the requirement that an FSA exhibit the risk-shifting and risk-distribution characteristics of insurance.[85]

V. VACATION BENEFIT RULES

Under the new section 125 regulation, vacation benefits included in a cafeteria plan must continue to be classified as either elective vacation days or nonelective vacation days.[86] Elective days are those days for which the individual may exercise some choice, either to buy or to sell,

83. Prop. Treas. Reg. § 1.125-2, Q&A-6(d), 54 Fed. Reg. 9460, 9502 (1989).
84. *See supra* notes 28-32.
85. Prop. Treas. Reg. § 1.125-2, Q&A-7(a), 54 Fed. Reg. 9460, 9502-03 (1989).
86. *Id.* Q&A-5(c)(1) at 9501. For prior guidance concerning vacation benefits in cafeteria plans, see Prop. Treas. Reg. § 1.125-1, Q&A-7, 49 Fed. Reg. 19,321, 19,324 (1984); Treas. Reg. § 1.125-2T (1986).

depending on the plan provisions.[87] Nonelective days are those days which are not subject to flex elections on any basis. If, for example, an individual has accrued three weeks of vacation for a year and participates in a cafeteria plan which allows participants to sell up to one week of vacation, then two weeks of vacation would be considered nonelective and one week considered elective. The regulation confirms the previous guidance that nonelective days are presumed to be used first and that elective days may not be carried over to another year.[88]

In a significant clarification, the regulation allows cafeteria plans to buy back any unused elective vacation days from participants at the end of the applicable plan year or calendar year.[89] In order to take advantage of this provision, the plan must pay the participant for the unused days prior to the end of the year.[90] This rule enables a participant to avoid forfeiture of unused vacation days purchased through the cafeteria plan.

As a practical matter, the cash-out option may prove to be difficult to implement for some employers. Because the unused vacation days must be cashed out before the end of the applicable year, the employer must complete all processing of the cash-out prior to the end of the year. Consider the case of an employer with a calendar year cafeteria plan who decides to implement the cash-out option. The employer must receive advance notification from those employees who wish to cash out unused vacation days prior to the last payroll period of the calendar year in order to make the cash-out payment during the year. In order to have time to make the necessary payroll adjustments for payment, the employer may need to impose a December 1 deadline for notification of vacation cash-outs.

Employers will have to verify that an employee electing a cash-out does in fact have unused elective days that may be cashed out. Further, the employee's supervisor should be notified of the employee's cash-out election and the corresponding reduction in available vacation days. If the employer is also in the process of re-enrolling employees the next plan year, this will add to the administrative tasks to be completed at year end. However, some employers do not find these administrative tasks insurmountable. Moreover, the cash-out approach is a convenient

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87. Prop. Treas. Reg. § 1.125-2, Q&A-5(c)(1), 54 Fed. Reg. 9460, 9501 (1989).

88. *Id.* Q&A-5(c)(2); *see also* Prop. Treas. Reg. § 1.125-1, Q&A-7, 49 Fed. Reg. 19,321, 19,324 (1984).

89. Prop. Treas. Reg. § 1.125-2, Q&A-5(c)(3), 54 Fed. Reg. 9460, 9501 (1989).

90. *Id.*

way to reconcile state laws prohibiting forfeiture of vacation days with cafeteria plan rules prohibiting the carryover of elective vacation days.

VI. Clarification Concerning Section 401(k) Plans

Section 125 provides that a cash or deferred feature of a qualified plan, commonly referred to as a "401(k) plan," may be included in a cafeteria plan.[91] This provision was designed to enable employees to make all of their elective benefit decisions under one program. However, some employers have not included a 401(k) plan in their cafeteria plan because of questions concerning various restrictions imposed by section 125. The proposed regulation has alleviated many of these concerns.

The section 125 regulation clarifies that the cafeteria plan restrictions upon mid-year elections are not applicable to elections otherwise allowed under a qualified plan with respect to both elective 401(k) contributions and after-tax employee contributions subject to section 401(m).[92] These mid-year elections will be permitted even if the qualified plan is part of a cafeteria plan.

A 401(k) plan may be included in a cafeteria plan even if the 401(k) plan allows for after-tax employee contributions and includes an employer matching contribution feature.[93] In addition, the new regulation allows a cafeteria plan to provide the opportunity for after-tax employee contributions and employer matching contributions (subject to section 401(m)) to a qualified plan.[94] The qualified plan need not include a 401(k) elective contribution feature.[95] Thus, the typical 401(k) plan design which includes features in addition to elective deferrals may be included in a cafeteria plan. Many employers will wish to continue separate documentation of a 401(k) plan or a thrift plan. However, the cafeteria plan may provide that certain benefits or credits with a cash option provided under the cafeteria plan may be used in connection with the 401(k) plan.

Employers wishing to redesign their cafeteria plan program to include a 401(k) plan should keep in mind that elective contributions to a

91. I.R.C. § 125(c)(2)(B).
92. Prop. Treas. Reg. § 1.125-2, Q&A-6(f), 54 Fed. Reg. 9460, 9502 (1989).
93. *Id.* Q&A-4(c), Q&A-5(b) at 9502-03.
94. *Id.* A "qualified plan" is a deferred compensation plan which satisfies the requirements of Code § 401(a). I.R.C. § 401(a). Qualified plans which include employee after-tax contributions and employer matching contributions are subject to nondiscrimination rules set forth in Code § 401(m). *Id.* § 401(m). These plans are often referred to as "thrift plans" even though they are technically qualified as either a "profit sharing plan" or a "stock bonus plan" under Code § 401(a). *Id.* § 401(a).
95. Prop. Treas. Reg. § 1.125-2, Q&A-4(c), Q&A-5(b), 54 Fed. Reg. 9460, 9501.

401(k) plan must be subject to a cash option. An option of "taxable benefits" will not suffice for a 401(k) plan even though such taxable benefits are treated as "cash" under the new section 125 regulation. If elective contributions to a qualified plan are not subject to a true cash option, then the plan will not constitute a qualified 401(k) plan.[96] As a result, both the 401(k) plan and the cafeteria plan may lose their tax-favored status.

Certain cafeteria plan designs which have been integrated with a qualified plan may benefit from these new rules but may have design problems due to other recently issued rules governing qualified plans. One such design is a "rollover design" which allows unused cafeteria plan credits to be contributed by the employer to a profit sharing or stock bonus plan which may or may not include a cash or deferred arrangement under section 401(k). Such contributions are not elective 401(k) contributions because the employee does not have a cash option with respect to such contributions. They are not after-tax employee contributions subject to section 401(m), and they are not employer matching contributions as defined in section 401(m)(4)(A). Some employers with this plan design have treated these contributions as employer "nonelective contributions" and may or may not use them as qualified nonelective contributions to satisfy the section 401(k) and (m) nondiscrimination tests.[97]

The rollover design appears to have problems which may affect the tax-favored status of both the cafeteria plan and the profit sharing or stock bonus plan. As discussed above, section 125 and the regulations thereunder allow a cafeteria plan to provide for after-tax employee contributions and employer matching contributions to a qualified plan as well as elective 401(k) contributions, in spite of the general prohibition of deferred compensation. However, the rollover design appears to provide an impermissible deferred compensation benefit because the employer nonelective contribution is not a permissible cafeteria plan benefit under the new regulation. Thus, the rollover design appears to cause a cafeteria

96. If the elective contributions are not subject to a cash or taxable benefit option, then they should fall outside of the cafeteria plan, and qualification issues should result only for the deferred compensation plan.

97. Employer "nonelective contributions" are employer contributions made to a profit-sharing or stock bonus plan other than pursuant to an employee's salary reduction agreement. *See* Treas. Reg. § 1.401(k)-1(g)(5) (1989). If such contributions are "qualified" within the meaning of Treas. Reg. § 1.401(k)-1(g)(7)(ii), then they may be used to satisfy the nondiscrimination test of Code § 401(k).

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plan to fail to satisfy section 125(c)(2).[98]

Qualification problems under section 401(a) can arise for the profit sharing or stock bonus plan to which employer nonelective contributions are made under the rollover design. Employer nonelective contributions may, but need not, be used to help the plan satisfy the nondiscrimination test of section 401(k) or (m) provided certain conditions are satisfied. Regardless of this application, such contributions must satisfy the general nondiscrimination rule of section 401(a)(4).[99]

Assuming that section 401(a)(4) is satisfied, the employer nonelective contributions under the rollover design appear to give rise to "separate benefit structures" under section 401(a)(26).[100] The proposed regulations under section 401(a)(26) provide that elective 401(k) contributions, 401(m) employee after-tax contributions, and 401(m) employer matching contributions do not constitute separate benefit structures for purposes of section 401(a)(26) if such contributions are available on a uniform basis to all plan participants.[101] Flex credit formulas are typically based in part on the employee's compensation and in part on fixed dollar amounts relating to health plan and similar benefits. In light of this and the fact that the employer nonelective contributions under the rollover design are based on the amount of *unused* credits, uniform availability will be difficult to demonstrate. *Qualified* nonelective employer contributions on behalf of some or all non-highly compensated employees do not give rise to a separate benefit structure if:

1. such contributions are used to satisfy the section 401(k) or (m) nondiscrimination tests, and
2. such contributions are not considered for purposes of determining whether any other employer contributions satisfy section 401(a)(4) or section 410(b).[102]

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98. It may be possible technically to avoid this problem by separately documenting the cafeteria plan and the qualified plan to which the employer nonelective contributions are made.

99. Prop. Treas. Reg. §§ 1.401(k)-1(b)(3), 1.401(m)-1(b)(2), 53 Fed. Reg. 29,719, 29,724, 29,731 (1988). If the employer nonelective contributions *help* the plan pass the section 401(k) or (m) test, then these contributions may arguably satisfy section 401(a)(4) by representing a greater percentage of compensation (on average) for low-paid employees than for high-paid employees. Of course this analysis could be affected by Code § 401(a)(4) regulations expected to be issued in the near future.

100. Code § 401(a)(26) prescribes a "minimum participation" rule under which each plan and each separate benefit structure therein must benefit the lesser of 50 employees or 40% of the employees of the employer. I.R.C. § 401(a)(26). Code § 401(a)(26) is effective for plan years beginning after December 31, 1988. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1112(e)(1), 101 Stat. 2085, 2445.

101. Prop. Treas. Reg. § 1.401(a)(26)-2(d)(4), 54 Fed. Reg. 6710, 6719 (1989).

102. *Id.* § 1.401(a)(26)-2(d)(4)(iii).

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This provision of the section 401(a)(26) regulation applies only with respect to qualified nonelective employer contributions for *non-highly compensated employees* and not with respect to such contributions on behalf of highly compensated employees. However, the rollover of unused flex credits is typically provided for highly compensated as well as non-highly compensated employees. Thus, the related profit sharing plan or stock bonus plan under a cafeteria plan using the rollover design could fail to be a qualified plan under section 401(a) for 1989 and future plan years.

VII. New Guidance On Nondiscrimination Rules for Cafeteria Plans

Section 125 imposes two nondiscrimination tests on cafeteria plans. One test requires that no more than 25% of the tax favored benefits provided under the cafeteria plan be provided to "key employees" as defined in section 416(i) of the Code.[103] The other test requires that the cafeteria plan be available to a classification of employees that does not discriminate in favor of highly compensated employees as defined in section 414(q) of the Code.[104]

The IRS recently issued proposed regulations concerning nondiscrimination rules for qualified retirement plans.[105] Part of this regulation includes new objective rules for the nondiscriminatory classification test frequently referred to as the "fair cross section test".[106] Prior to issuance of this proposed regulation, the nondiscriminatory classification test was primarily a "facts and circumstances" test and was set forth in various IRS rulings and court decisions.[107] The IRS has indicated that this new rule for the nondiscriminatory classification test applies to various nonretirement plans, including cafeteria plans governed under section 125.[108] If a cafeteria plan fails the nondiscriminatory classification test, all of the highly compensated employees will have taxable income to the extent of the cash they could have received under the cafeteria plan.[109]

Under the new nondiscriminatory classification test rules, an eligibility classification established by an employer for a cafeteria plan must

103. I.R.C. § 125(b)(2).
104. *Id.* § 125(b)(1).
105. Prop. Treas. Reg. § 1.410(b)-0 to (b)-10, 54 Fed. Reg. 21,437 (1989).
106. *Id.* § 1.410(b)-4 at 21,444.
107. *See* Rev. Rul. 83-58, 1983-1 C.B. 95 (interpreting Treas. Reg. § 1.410(b)-1 (1980)); *see also* Commissioner v. Pepsi-Cola Niagra Bottling Corp., 399 F.2d 390 (7th Cir. 1968); Rev. Rul. 74-256, 1974-1 C.B. 94 (both interpreting the statutory predecessor to Code § 410(b)).
108. Prop. Treas. Reg. § 1.410, 54 Fed. Reg. 21,437 (1989).
109. I.R.C. § 125(b)(1).

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be "reasonable" and "nondiscriminatory."[110] Reasonable classifications include those based on job categories, compensation categories (*e.g.*, salaried or hourly), and similar bona fide business criteria.[111] A list of employees by name will not be considered a reasonable classification.[112]

In addition to being reasonable, the eligible class must not discriminate in favor of highly compensated employees.[113] Under the new nondiscriminatory classification test, the percentage of non-highly compensated employees eligible for the cafeteria plan is compared to the percentage of highly compensated employees eligible for the cafeteria plan (the "eligibility ratio").[114] A cafeteria plan will satisfy the nondiscrimination requirement if either (1) the eligibility ratio is greater than the applicable safe harbor percentage (see table), or (2) the eligibility ratio is less than the applicable safe harbor percentage but greater than the unsafe harbor percentage, and the plan eligibility rules satisfy a facts and circumstances test.[115]

A cafeteria plan falls within the unsafe harbor rule and is automatically deemed discriminatory if the eligibility ratio is less than the unsafe harbor percentage.[116] The safe harbor and the unsafe harbor percentages vary depending on the extent to which the total employee group includes non-highly compensated employees.[117] The "concentration percentage" of non-highly compensated employees is the percentage of all nonexcludable employees who are not highly compensated employees.[118] For example, if the concentration percentage of non-highly compensated employees is 60% or less, then the safe harbor percentage is 50% and the unsafe harbor percentage is 40%. As the concentration percentage of non-highly compensated employees increases, the safe harbor and unsafe harbor percentages decrease as reflected in the table.

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110. Prop. Treas. Reg. § 1.410(b)-4(a), 54 Fed. Reg. 21,437, 21,439 (1989).

111. *Id.* § 1.410(b)-4(b).

112. *Id.*

113. *Id.* § 1.410(b)-4(a).

114. *Id.* § 1.410(b)-4(c). These percentages are calculated by considering all employees in the controlled group of employers (as determined by application of Code § 414 (b), (c), (m), (o)). *Id.* § 1.410 (b)-9(b). However, certain excludable employees may be disregarded. *See id.* § 1.410 (b)-4(c)(4)(v), (5) at 21,445; *see also* I.R.C. § 125(b)(3).

115. *Id.* § 1.410(b)-4(c).

116. *Id.* § 1.410(b)-4(c)(2).

117. *Id.* § 1.410(b)-4(c)(4)(iii), (iv), (vi).

118. *Id.* § 1.410(b)-4(c)(4)(v). Employees which are excludable are those which may be disregarded for purposes of the average benefits test of § 410(b)(2). *Id.* These excludable employees are identified in Prop. Treas. Reg. § 1.410(b)-6 for purposes of qualified retirement plans. However, the identification of excludable employees for purposes of testing a cafeteria plan should be with reference to § 89(h) as indicated in § 125(b)(3).

If the eligibility ratio exceeds the unsafe harbor percentage but does not exceed the safe harbor percentage, then a facts and circumstances test applies.[119] The proposed regulation indicates that the following facts and circumstances are relevant in determining whether a classification is discriminatory:

1. the underlying business reason for the classification, which must be a reason other than reducing benefit costs,
2. the percentage of the employer's employees eligible under the cafeteria plan,
3. whether the number of employees eligible for the cafeteria plan in each salary range is representative of the number of employees in each salary range of the employer's workforce,
4. the extent to which the eligibility classification is close to satisfying the safe harbor rule.[120]

None of these facts alone is determinative, and other facts and circumstances may be relevant.[121]

Employers with numerous cafeteria plans established by or for various subsidiaries may find that some of their cafeteria plans fall within the unsafe harbor. Such cafeteria plans will have to be discontinued or consolidated with other cafeteria plans, or the eligibility thereunder will have to be effectively limited to non-highly compensated employees. Employers with cafeteria plans that must rely on the facts and circumstances test should consider revising the cafeteria plan eligibility rules, particularly if the employee group varies seasonally, because the nondiscriminatory classification test must be satisfied on at least one day in each calendar quarter.[122]

The new guidance on the nondiscriminatory classification test is effective for plan years beginning on or after January 1, 1989.[123] However, employers may apply the prior facts and circumstances rule for the 1989 plan year and the new rules thereafter.[124]

VIII. CONCLUSION

The proposed section 125 regulation represents another positive step in the continuing development of flexible compensation. While the regulation has, to some extent, reduced the advantages of FSA's for health

119. *Id.* § 1.410(b)-4(c)(1), (3) at 21,444.
120. *Id.* § 1.410(b)-4(c)(iii).
121. *Id.*
122. *Id.* § 1.410(b)-8(a)(1) at 21,449.
123. *Id.* § 1.410(b)-10(a) at 21,450.
124. *Id.* § 1.410(b)-10(b)(1).

care expenses, it has also provided helpful and significant clarification concerning numerous aspects of cafeteria plans. The proposed regulation concerning the nondiscriminatory classification test may require some employers to redesign eligibility rules for their cafeteria plans. However, an objective nondiscrimination rule with a safe harbor is generally welcome guidance. The ultimate impact of these regulations may be to establish more clearly defined rules for cafeteria plans, thus encouraging more employers to adopt such plans in the future.

TABLE
SAFE/UNSAFE HARBOR TABLE

Non-Highly Compensated Employee Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
0 -60%	50%	40%
61%	49.25%	39.25%
62%	48.50%	38.50%
63%	47.75%	37.75%
64%	47%	37%
65%	46.25%	36.25%
66%	45.50%	35.50%
67%	44.75%	34.75%
68%	44%	34%
69%	43.25%	33.25%
70%	42.50%	32.50%
71%	41.75%	31.75%
72%	41%	31%
73%	40.25%	30.25%
74%	39.50%	29.50%
75%	38.75%	28.75%
76%	38%	28%
77%	37.25%	27.25%
78%	36.50%	26.50%
79%	35.75%	25.75%
80%	35%	25%
81%	34.25%	24.25%
82%	33.50%	23.50%
83%	32.75%	22.75%
84%	32%	22%
85%	31.25%	21.25%
86%	30.50%	20.50%
87%	29.75%	20%
88%	29%	20%
89%	28.25%	20%
90%	27.50%	20%
91%	26.75%	20%
92%	26%	20%
93%	25.25%	20%
94%	24.50%	20%
95%	23.75%	20%
96%	23%	20%
97%	22.25%	20%
98%	21.50%	20%
99%	20.75%	20%