

CAFETERIA PLAN REQUIREMENTS AND RELATED RULES

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CAFETERIA PLAN REQUIREMENTS AND RELATED RULES

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I. Introduction. A “cafeteria plan” or “flexible benefits plan” (referred to in this outline as a “cafeteria plan”) is a fringe benefit plan that allows a participant to personally choose among employer-provided taxable and nontaxable benefits to satisfy his particular objectives. It should be as simple in operation as it is in concept.

The Federal income tax advantage of a properly structured cafeteria plan is that despite being allowed the choice among taxable and nontaxable benefits, participants are taxed only on the value of any taxable benefits they select under the plan, even though the employer contributions to the plan are generally deductible. At the heart of any cafeteria plan is this concept: the right to choose (and decline otherwise taxable income) is allowed under an exception to the constructive receipt rules that would otherwise apply to this choice. Prop. Treas. Reg §1.125-1, Q&A-9, 49 Fed. Reg. 19321 (May 7, 1984). These constructive receipt rules, according to the proposed regulations, generally would require an individual choosing among taxable and nontaxable benefits to include the value of any available taxable benefits, even if the election was both available and made before the taxable benefits were available. The costs of this advantage are the rules described in this outline.

Temporary Regulations. The technical requirements regarding the design and operation of cafeteria plans are set forth in section 125 (“Section 125”) of the Internal Revenue Code of 1986, as amended (the “Code”). Temporary regulations addressing primarily the question of what benefits may be offered to participants under a cafeteria plan were issued on February 4, 1986. Temp. Treas. Reg. §1.1252T, 51 Fed. Reg. 4391 (February 4, 1986) (the “1986 Temporary Regulations”). Temporary regulations released in 1997 significantly changed (albeit temporarily) the mid-period change in election rules for health and group-term life insurance benefits. Temp. Treas. Reg. §1.125-4T, 62 Fed. Reg. 60165 (November 7, 1997) (the “1997 Temporary Regulations”).

Proposed Regulations. The Internal Revenue Service (the “Service”) and the Treasury Department have also issued multiple sets of proposed regulations regarding cafeteria plans. Two

sets of proposed regulations were issued in 1984. Prop. Treas. Reg. §1.1251, Q&As 1-21, 49 Fed. Reg. 19321 (May 7, 1984), and Prop. Treas. Reg. §1.125-1, Q&As 21-29, 49 Fed. Reg. 50733 (December 26, 1984) (together the “1984 Regulations”). Additional proposed regulations were published on March 7, 1989. Prop. Treas. Reg. §1.125-1, Q&A-30 and Prop. Treas. Reg. §1.1252, 54 Fed. Reg. 9460 (March 7, 1989) (the “1989 Regulations”), but the 1989 Regulations should be used with care since they were based in part on statutory provisions repealed when section 89 of the Code was repealed. More proposed regulations were issued in December 1995. Prop. Treas. Reg. §1.125-3, 60 Fed. Reg. 66229 (December 21, 1995) (the “Proposed FMLA Regulations”). 1997 saw the withdrawal of a piece of the 1989 Regulations and the issuance of even more proposed regulations (the “1997 Proposed Regulations”) (most of which were also issued as the 1997 Temporary Regulations) to significantly rework parts of both the 1984 Regulations and the 1989 Regulations. Notice of Partial Withdrawal of Previous Proposal and New Proposed Rules on Changing Cafeteria Plan Elections, REG-243025-96, 62 Fed. Reg. 60196 (November 7, 1997) (the “1997 Notice”). Although none of the proposed regulations will be effective until they are issued in final form, the Service has stated that it will apply most of the proposed regulations in issuing rulings and in examining taxpayers and cafeteria plans. Notice of Proposed Rulemaking EE-16-79; Notice of Proposed Rulemaking EE-130-86; Notice of Proposed Rulemaking EE-20-95 (“Except as otherwise provided in this notice. . . , all of the existing rules governing cafeteria plans. . . continue to apply.”). Recent informal indications from the Service suggest that the existing proposed regulations will be revoked and replaced with one comprehensive set of new proposed regulations.

1989 Regulations. The 1989 Regulations clarified some issues left open under the 1984 Regulations. To the extent that the 1989 Regulations were inconsistent with the 1986 Temporary Regulations or the 1984 Regulations, the 1989 Regulations controlled. Prop. Treas. Reg. §1.1251, Q&A30; Notice of Proposed Rulemaking EE-130-86. The Service has also stated, however, that to the extent the 1989 Regulations clarify the 1986 Temporary Regulations or the 1984 Regulations and are more restrictive, the Service will apply those parts of the 1989 Regulations using effective dates determined with reference to the effective dates under now-repealed section 89 of the Code and Proposed Treasury Regulation section 1.89(a)-10. Notice of Proposed Rulemaking EE-130-86. Query whether these effective date rules continue unchanged after the repeal of Section 89.

Proposed FMLA Regulations. The Proposed FMLA Regulations were a separate set of proposed regulations that had no impact on existing guidance. Taxpayers were allowed to rely on the guidance in the Proposed FMLA Regulations, and the Service could have applied them. Prop. Treas. Reg. § 1.125-3, Q&A-8(a).

1997 Regulations. The 1997 Proposed Regulations did not supplant all of the 1989 Regulations nor all of the 1984 Regulations. They did, however, preempt the earlier guidance on the subject matters they addressed. Since parts of the 1997 Proposed Regulations were also published as the 1997 Temporary Regulations, compliance with much of the 1997 guidance was to become mandatory beginning on the effective date of the 1997 Temporary Regulations for a cafeteria plan. At first, the 1997 Temporary Regulations were to be effective for plan years beginning after December 31, 1998. Temp. Treas. Reg. §1.125-4T(1). That effective date was changed. Next, both the 1997 Temporary Regulations and the 1997 Proposed Regulations were “not to be effective before plan years beginning at least 120 days after further guidance [presumably related to the change in status

rules] is issued.” Announcement 98-105, 1998-49 I.R.B. 21 (December 7, 1998) (“Announcement 98-105”). Ultimately, the 1997 Temporary Regulations were effective for a discrete period of time.

Final Change in Status Regulations. On March 23, 2000, the first final cafeteria plan regulations were published to adopt new Treasury Regulations section 1.125-4, regarding permitted mid-period election changes, and to once again change the effective date of Temporary Treasury Regulations section 1.125-4T(l). Treasury Decision 8878, 65 Federal Register 15548 (March 23, 2000). At the same time, more proposed regulations were issued, principally to publish new significant cost or coverage change rules (the “2000 Proposed Regulations”). Partial Withdrawal of Notice of Proposed Rulemaking; Amendment to Notice of Proposed Rulemaking and Notice of Proposed Rulemaking. REG-117162-99, 65 Fed. Reg. 15587 (March 23, 2000) (the “2000 Notice”). The first final regulations finalized the 1997 Proposed Regulations. Notice of Partial Withdrawal of Previous Proposal and New Proposed Rules on Changing Cafeteria Plan Elections, REG-243025-96, 62 Fed. Reg. 60196 (November 7, 1997).

The second set of final regulations was published on January 10, 2001 to “address all of the changes in status for which a cafeteria plan may permit election changes,” including finalizing the significant changes in cost and coverage exceptions in the 2000 Proposed Regulations and making some changes to the first final regulations. Treasury Decision 8921, 66 Federal Register 1837 (January 10, 2001) (“T.D. 8921”).

Final FMLA Regulations. The third set of final regulations was published on October 17, 2001 to finalize the Proposed FMLA Regulations. Treasury Decision 8966, 66 Federal Register 52675 (October 17, 2001) (“T.D. 8966”).

Discrimination Rules. In addition, cafeteria plans are also subject to various extra nondiscrimination rules depending on the benefits they provide. The Tax Reform Act of 1986 (the “1986 Act”) enacted section 89 of the Code to impose new nondiscrimination rules applicable to cafeteria plans that provided accident and health benefits, group-term life insurance benefits, group legal service benefits and dependent care assistance benefits. Section 89 also imposed certain plan documentation requirements on cafeteria plans and certain “statutory employee benefit plans.” Section 89 was repealed in its entirety on November 8, 1989, and the nondiscrimination rules applicable to cafeteria plans themselves and to various benefits that can be offered through cafeteria plans before enactment of Section 89 have been reinstated. Increasing the Public Debt Limit, Public Law No. 101-140, 103 Stat. 830 (1989) (“P. L. 101-140”). The repeal is effective as if it were included in the 1986 Act. P. L. 101-140, §§ 202(c), 203(c). Accordingly, cafeteria plans are now subject to the multiplicity of nondiscrimination rules that existed prior to the 1986 Act, including the period from 1986 forward. Did the retroactive change of the applicable discrimination rules under section 125 of the Code retroactively disqualify cafeteria plans that complied only with the 1986 Act rules (during their brief tenure)?

II. Consequences of Failing to Comply. As stated above, Section 125 creates an exception to the Code’s constructive receipt rules. Failing to comply with the rules imposed on the plan by Section 125 (other than the nondiscrimination rules) dissolves the protection of Section 125 and requires all participants to include in gross income (regardless of the rule failed) the taxable benefits