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2009-02

NEW CAFETERIA PLAN (SECTION 125) REGULATIONS

In August, 2007 the IRS issued proposed Cafeteria Plan (Section 125) regulations which become effective for plan years beginning on and after January 1, 2009⁽¹⁾. For the most part, the new regulations consolidate prior temporary and proposed regulations while maintaining existing practices. The following summarizes some key elements of the proposed regulations:

- A. ***There must be a separate written Section 125 document*** that describes the benefits offered, eligibility, participation and election procedures (and that annual elections are irrevocable except in certain circumstances), how employer contributions may be made (e.g. salary reduction), the maximum amount of elective contributions, and the rules and procedures relative to mid-year election changes. Other plan specific requirements, such as FSA “use-it-or-lose-it”, uniform coverage and grace period provisions must also be in writing. While the need to have a written document is not a new provision, the requirements are quite specific. Be aware that under the proposed regulations, there is currently no provision to correct accidental mistakes or omissions, retroactively, as the regulations clearly state that plan changes can only be recognized by prospectively amending the plan.
- B. ***Ensure that all required discrimination tests are performed in a timely manner.*** The regulations now stipulate that all section 125 plans, including: cafeteria plans, FSA medical and dependent care plans, life insurance plans and self-insured medical plans are subject to nondiscrimination testing requirements that must be performed on **the last day of the plan year**. Failure to pass any one of three nondiscrimination tests that include: Eligibility, Key Employee Concentration or a Contribution and Benefits test, can lead to substantial tax implications for certain participants.
- C. ***Cafeteria Plans must offer a choice between at least one qualified (nontaxable) and one taxable benefit.*** Healthcare (medical, dental, vision) life and AD&D, as well as flexible spending accounts continue to be qualified benefits. COBRA premiums and contributions to Health Savings Accounts (HSAs) are also considered qualified benefits. Examples of taxable benefits include: cash/wages (in lieu of other benefits), benefits that can be purchased with after-tax employee contributions, paid time-off and other paid leave, and taxable employer-paid benefits (e.g. basic life insurance). Employees also have the ability to make monthly contributions to HSAs and are allowed to prospectively modify HSA contribution amounts at any time during the year (subject to contribution limitations).



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D. ***Other features of the regulations include:*** requiring the use of a Table 1 to calculate imputed income from life insurance, not allowing a change in plan year except for a valid business purpose, and making it easier for employers to substantiate and monitor FSA expenses reimbursed with debit cards.

Finally, it is believed that the IRS intends to increase its Section 125 Plan audit activity in 2009 and employers should take all necessary steps to ensure that their Cafeteria Plans are updated and tested in accordance with IRS regulations.

Notes:

(1) There is some indication that the effective date may be delayed until January 1, 2010. However, if and when any further guidance is issued, employers should assume that the regulations became effective on January 1, 2009 and take appropriate actions.

For more information, please contact your Chernoff Diamond consultant.

This notice is a brief summary of the changes to the Cafeteria Plan (Section 125) regulations and is not intended to be a comprehensive legislative analysis. Chernoff Diamond & Co., LLC is a benefits advisory firm and does not provide tax or legal advice. Employers should consult with qualified legal and/or tax counsel for guidance in respect of matters of law, tax and related regulation.