Internal Revenue Code Sections

IRC, 2023-CODE-VOL, SEC. 125. CAFETERIA PLANS.

SEC. 125. CAFETERIA PLANS.
125(a) IN GENERAL. --Except as provided in subsection (b), no amount shall be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan.
125(b) EXCEPTION FOR HIGHLY COMPENSATED PARTICIPANTS AND KEY EMPLOYEES. --
125(b)(1) HIGHLY COMPENSATED PARTICIPANTS. --In the case of a highly compensated participant, subsection (a) shall not apply to any benefit attributable to a plan year for which the plan discriminates in favor of --
125(b)(1)(A) highly compensated individuals as to eligibility to participate, or
125(b)(1)(B) highly compensated participants as to contributions and benefits.
125(b)(2) KEY EMPLOYEES. --In the case of a key employee (within the meaning of section 416(i)(1)), subsection (a) shall not apply to any benefit attributable to a plan [year] for which the statutory nontaxable benefits provided to key employees exceed 25 percent of the aggregate of such benefits provided for all employees under the plan. For purposes of the preceding sentence, statutory nontaxable benefits shall be determined without regard to the second sentence of subsection (f).
125(b)(3) YEAR OF INCLUSION. --For purposes of determining the taxable year of inclusion, any benefit described in paragraph (1) or (2) shall be treated as received or accrued in the taxable year of the participant or key employee in which the plan year ends.
125(c) DISCRIMINATION AS TO BENEFITS OR CONTRIBUTIONS. --For purposes of subparagraph (B) of subsection (b)(1), a cafeteria plan does not discriminate where qualified benefits and total benefits (or employer contributions allocable to statutory nontaxable benefits and employer contributions for total benefits) do not discriminate in favor of highly compensated participants.
125(d) CAFETERIA PLAN DEFINED. --For purposes of this section --
125(d)(1) IN GENERAL. --The term "cafeteria plan" means a written plan under which --
125(d)(1)(A) all participants are employees, and
125(d)(1)(B) the participants may choose among 2 or more benefits consisting of cash and qualified benefits.
125(d)(2) DEFERRED COMPENSATION PLANS EXCLUDED. --
125(d)(2)(A) IN GENERAL. --The term "cafeteria plan" does not include any plan which provides for deferred compensation.
125(d)(2)(B) EXCEPTION FOR CASH AND DEFERRED ARRANGEMENTS. --Subparagraph (A) shall not apply to a profit-sharing or stock bonus plan or rural cooperative plan (within the meaning of section 401(k)(7)) which includes a qualified cash or deferred arrangement (as defined in section 401(k)(2)) to the extent of amounts which a covered employee may elect to have the employer pay as contributions to a trust under such plan on behalf of the employee.
125(d)(2)(C) EXCEPTION FOR CERTAIN PLANS MAINTAINED BY EDUCATIONAL INSTITUTIONS. --Subparagraph (A) shall not apply to a plan maintained by an educational organization described in section 170(b)(1)(A)(ii) to the extent of amounts which a covered employee may elect to have the employer pay as contributions for post-retirement group life
PENIRC S 125 Page 1 of 3
http://hr.cch.com/primesrc/bin/highwire.dll 9/30/2008
insurance if --
125(d)(2)(C)(i) all contributions for such insurance must be made before retirement, and
125(d)(2)(C)(ii) such life insurance does not have a cash surrender value at any time.
For purposes of section 79, any life insurance described in the preceding sentence shall be treated as group-term life insurance.
125(d)(2)(D) EXCEPTION FOR HEALTH SAVINGS ACCOUNTS. --Subparagraph (A) shall not apply to a plan to the extent of amounts which a covered employee may elect to have the employer pay as contributions to a health savings account established on behalf of the employee.
125(e) HIGHLY COMPENSATED PARTICIPANT AND INDIVIDUAL DEFINED. --For purposes of this section --
125(e)(1) HIGHLY COMPENSATED PARTICIPANT. --The term "highly compensated participant" means a participant who is --
125(e)(1)(A) an officer,
125(e)(1)(B) a shareholder owning more than 5 percent of the voting power or value of all classes of stock of the employer,
125(e)(1)(C) highly compensated, or
125(e)(1)(D) a spouse or dependent (within the meaning of section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof) of an individual described in subparagraph (A), (B), or (C).
125(e)(2) HIGHLY COMPENSATED INDIVIDUAL. --The term "highly compensated individual" means an individual who is described in subparagraph (A), (B), (C), or (D) of paragraph (1).
125(f) QUALIFIED BENEFITS DEFINED. --For purposes of this section – (1**) In general**. the term "qualified benefit" means any benefit which, with the application of subsection (a), is not includible in the gross income of the employee by reason of an express provision of this chapter (other than section 106(b), 117, 127, or 132). Such term includes any group term life insurance which is includible in gross income only because it exceeds the dollar limitation of section 79 and such term includes any other benefit permitted under regulations. (2) **Long-term care insurance not qualified.** The term "qualified benefit" shall not include any product which is advertised, marketed, or offered as long-term

care insurance. (3) **Certain exchange-participating qualified health plans not qualified.** (A) In general. The term “qualified benefit” shall not include any qualified health plan (as defined in section 1301(a) of the Patient Protection and Affordable Care Act) offered through an Exchange established under section 1311 of such Act. (B) Exception for exchange-eligible employers. Subparagraph (A) shall not apply with respect to any employee if such employee's employer is a qualified employer (as defined in section 1312(f)(2) of the Patient Protection and Affordable Care Act) offering the employee the opportunity to enroll through such an Exchange in a qualified health plan in a group market.

125(g) SPECIAL RULES. --

125(g)(1) COLLECTIVELY BARGAINED PLAN NOT CONSIDERED DISCRIMINATORY. --For purposes of this section, a plan shall not be treated as discriminatory if the plan is maintained under an agreement which the Secretary finds to be a collective bargaining agreement between employee representatives and one or more employers.

125(g)(2) HEALTH BENEFITS. --For purposes of subparagraph (B) of subsection (b)(1), a cafeteria plan which provides health benefits shall not be treated as discriminatory if --

125(g)(2)(A) contributions under the plan on behalf of each participant include an amount which --

125(g)(2)(A)(i) equals 100 percent of the cost of the health benefit coverage under the plan of the majority of the highly compensated participants similarly situated, or

125(g)(2)(A)(ii) equals or exceeds 75 percent of the cost of the health benefit coverage of the participant (similarly situated) having the highest cost health benefit coverage under the plan, and

PENIRC S 125 Page 2 of 3

http://hr.cch.com/primesrc/bin/highwire.dll 9/30/2008

125(g)(2)(B) contributions or benefits under the plan in excess of those described in subparagraph (A) bear a uniform relationship to compensation.

125(g)(3) CERTAIN PARTICIPATION ELIGIBILITY RULES NOT TREATED AS DISCRIMINATORY. --For purposes of subparagraph (A) of subsection (b)(1), a classification shall not be treated as discriminatory if the plan --

125(g)(3)(A) benefits a group of employees described in section 410(b)(2)(A)(i), and

125(g)(3)(B) meets the requirements of clauses (i) and (ii):

125(g)(3)(B)(i) No employee is required to complete more than 3 years of employment with the employer or employers maintaining the plan as a condition of participation in the plan, and the employment requirement for each employee is the same.

125(g)(3)(B)(ii) Any employee who has satisfied the employment requirement of clause (i) and who is otherwise entitled to participate in the plan commences participation no later than the first day of the first plan year beginning after the date the employment requirement was satisfied unless the employee was separated from service before the first day of that plan year.

125(g)(4) CERTAIN CONTROLLED GROUPS, ETC. --All employees who are treated as employed by a single employer under subsection (b), (c), or (m) of section 414 shall be treated as employed by a single employer for purposes of this section.

125(h) SPECIAL RULE FOR UNUSED BENEFITS IN HEALTH FLEXIBLE SPENDING ARRANGEMENTS OF INDIVIDUALS CALLED TO ACTIVE DUTY. --

125(h)(1) IN GENERAL. --For purposes of this title, a plan or other arrangement shall not fail to be treated as a cafeteria plan or health flexible spending arrangement (and shall not fail to be treated as an accident of health plan) merely because such arrangement provides for qualified reservist distributions.

125(h)(2) QUALIFIED RESERVIST DISTRIBUTION. --For purposes of this subsection, the term "qualified reservist distribution" means, [sic] any distribution to an individual of all or a portion of the balance in the employee's account under such arrangement if --

125(h)(2)(A) such individual was (by reason of being a member of a reserve component (as defined in section 101 of title 37, United States Code)) ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and

125(h)(2)(B) such distribution is made during the period beginning on the date of such order or call and ending on the last date that reimbursements could otherwise be made under such arrangement for the plan year which includes the date of such order or call.

125(i) Limitation on health flexible spending arrangements.

(1) **In general**. For purposes of this section, if a benefit is provided under a cafeteria plan through employer contributions to a health flexible spending arrangement, such benefit shall not be treated as a qualified benefit unless the cafeteria plan provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of $2,500 made to such arrangement. (2) **Adjustment for inflation.** In the case of any taxable year beginning after December 31, 2013, the dollar amount in paragraph (1) shall be increased by an amount equal to— (A) such amount, multiplied by (B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which such taxable year begins by substituting “calendar year 2012” for “calendar year 1992” in subparagraph (B) thereof. If any increase determined under this paragraph is not a multiple of $50, such increase shall be rounded to the next lowest multiple of $50.

(**j**) Simple cafeteria plan for small businesses. (added 3/10)

(1) In general.- An eligible employer maintaining a simple cafeteria plan with respect to which the requirements of this subsection are met for any year shall be treated as meeting any applicable nondiscrimination requirement during such year.

(2)Simple cafeteria plan.- For purposes of this subsection , the term “simple cafeteria plan” means a cafeteria plan—

(A) which is established and maintained by an eligible employer, and

(B) with respect to which the contribution requirements of paragraph (3) , and the eligibility and participation requirements of paragraph (4) , are met.

(3) Contribution requirements.

(A)In general.- The requirements of this paragraph are met if, under the plan the employer is required, without regard to whether a qualified employee makes any salary reduction contribution, to make a contribution to provide qualified benefits under the plan on behalf of each qualified employee in an amount equal to—

(i)a uniform percentage (not less than 2 percent) of the employee's compensation for the plan year, or

(ii)an amount which is not less than the lesser of

(I) 6 percent of the employee's compensation for the plan year, or

(II) twice the amount of the salary reduction contributions of each qualified employee.

(B) Matching contributions on behalf of highly compensated and key employees. The requirements of subparagraph (A)(ii) shall not be treated as met if, under the plan, the rate of contributions with respect to any salary reduction contribution of a highly compensated or key employee at any rate of contribution is greater than that with respect to an employee who is not a highly compensated or key employee.
(C)Additional contributions.- Subject to subparagraph (B) , nothing in this paragraph shall be treated as prohibiting an employer from making contributions to provide qualified benefits under the plan in addition to contributions required under subparagraph (A) .
(D) Definitions. - For purposes of this paragraph —
((i)) Salary reduction contribution. - The term “salary reduction contribution” means, with respect to a cafeteria plan, any amount which is contributed to the plan at the election of the employee and which is not includible in gross income by reason of this section .
((ii))Qualified employee. - The term “qualified employee” means, with respect to a cafeteria plan, any employee who is not a highly compensated or key employee and who is eligible to participate in the plan.
((iii))Highly compensated. - The term “highly compensated employee” has the meaning given such term by section 414(q).
((iv))Key employee. - The term “key employee” has the meaning given such term by section 416(i) .
(4) Minimum eligibility and participation requirements.
(A) In general. - The requirements of this paragraph shall be treated as met with respect to any year if, under the plan—
(i) all employees who had at least 1,000 hours of service for the preceding plan year are eligible to participate, and
(ii) each employee eligible to participate in the plan may, subject to terms and conditions applicable to all participants, elect any benefit available under the plan.
(B) Certain employees may be excluded. - For purposes of subparagraph (A)(i) , an employer may elect to exclude under the plan employees—
(i) who have not attained the age of 21 before the close of a plan year,
(ii) who have less than 1 year of service with the employer as of any day during the plan year,
(iii) who are covered under an agreement which the Secretary of Labor finds to be a collective bargaining agreement if there is evidence that the benefits covered under the cafeteria plan were the subject of good faith bargaining between employee representatives and the employer, or
(iv) who are described in section 410(b)(3)(C) (relating to nonresident aliens working outside the United States). A plan may provide a shorter period of service or younger age for purposes of clause (i) or (ii).
(5) Eligible employer. - For purposes of this subsection—
(A) In general. - The term “eligible employer” means, with respect to any year, any employer if such employer employed an average of 100 or fewer employees on business days during either of the 2 preceding years. For purposes of this subparagraph , a year may only be taken into account if the employer was in existence throughout the year.
(B) Employers not in existence during preceding year. - If an employer was not in existence throughout the preceding year, the determination under subparagraph (A) shall be based on the average number of employees that it is reasonably expected such employer will employ on business days in the current year.
(C) Growing employers retain treatment as small employer. -
(i) EBIA In general. If—
(I) an employer was an eligible employer for any year (a “qualified year”), and
(II) such employer establishes a simple cafeteria plan for its employees for such year, then, notwithstanding the fact the employer fails to meet the requirements of subparagraph (A) for any subsequent year, such employer shall be treated as an eligible employer for such subsequent year with respect to employees (whether or not employees during a qualified year) of any trade or business which was covered by the plan during any qualified year.
(ii) Exception. - This subparagraph shall cease to apply if the employer employs an average of 200 or more employees on business days during any year preceding any such subsequent year.
(D) Special rules.-
(i) Predecessors. - Any reference in this paragraph to an employer shall include a reference to any predecessor of such employer.
(ii) Aggregation rules. - All persons treated as a single employer under subsection (a) or (b) of section 52 , or subsection (n) or (o) of section 414 , shall be treated as one person.
(6) Applicable nondiscrimination requirement. - For purposes of this subsection , the term “applicable nondiscrimination requirement” means any requirement under subsection (b) of this section, section 79(d) , section 105(h) , or paragraph (2) , (3) , (4) , or (8) of section 129(d).
(7) Compensation. - The term “compensation” has the meaning given such term by section 414(s).
(k) Cross reference.- For reporting and recordkeeping requirements, see section 6039D.
(l)Regulations.- The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this section.

Table of contents, REG-142695-05, 8/6/2007.

§1.125-1 Cafeteria plans; general rules.

(a) Definitions.

(b) General rules.

(c) Written plan requirements.

(d) Plan year requirements.

(e) Grace period.

(f) Run-out period.

(g) Employee for purpose of Section 125.

(h) After-tax employee contributions.

(i) Prohibited taxable benefits.

(j) Coordination with other rules.

(k) Group-term life insurance.

(l) COBRA premiums.

(m) Payment or reimbursement of employees' individual accident and health insurance premiums.

(n) Section 105 rules for accident and health plan offered through a cafeteria plan.

(o) Prohibition against deferred compensation.

(p) Benefits relating to more than one year.

(q) Nonqualified benefits.

(r) Employer contributions to a cafeteria plan.

(s) Effective/applicability date.

§1.125-2 Cafeteria plans; elections.

(a) Rules relating to making elections and revoking elections.

(b) Automatic elections.

(d) Election rules for salary reduction contributions to HSAs.

(d) Optional election for new employees.

(e) Effective/applicability date.

§1.125-3 Effect of Family Medical Leave Act (FMLA) on the operation of cafeteria plans

§1.125-4 Permitted election changes

(a) Election changes

(b) Special enrollment rights

(d) Changes in status

(d) Judgment, decree, or order

(e) Entitlement to Medicare or Medicaid

(f) Significant cost or coverage changes

(g) Special requirements relating to the Family and Medical Leave Act

(h) Elective contributions under a qualified cash or deferred arrangement

(d) Definitions

(e) Effective date

§1.125-5 Flexible spending arrangements.

(a) Definition of flexible spending arrangement.

(b) Flex-credits allowed.

(c) Use-or-lose rule.

(d) Uniform coverage rules applicable to health FSAs.

(e) Required period of coverage for a health FSA, dependent care FSA and adoption assistance FSA.

(f) Coverage on a month-by-month or expense-by-expense basis prohibited.

(g) FSA administrative practices.

(h) Qualified benefits permitted to be offered through a FSA.

(i) Section 129 rules for dependent care assistance program offered through a cafeteria plan.

(j) Section 137 rules for adoption assistance program offered through a cafeteria plan.

(k) FSAs and the rules governing the tax-favored treatment of employer-provided health benefits.

(l) Section 105(h) requirements.

(m) HSA-compatible FSAs- limited-purpose health FSAs and post-deductible health FSAs.

(n) Qualified HSA distributions.

(o) FSA experience gains or forfeitures.

(p) Effective/applicability date.

§1.125-6 Substantiation of expenses for all cafeteria plans.

(a) Cafeteria plan payments and reimbursements.

(b) Rules for claims substantiation for cafeteria plans.

(c) Debit cards - overview.

(d) Mandatory rules for all debit cards usable to pay or reimburse medical expenses.

(e) Substantiation of expenses incurred at medical care providers and certain other stores with Drug Stores and Pharmacies merchant category code.

(f) Inventory information approval system.

(g) Debit cards used to pay or reimburse dependent care assistance.

(h) Effective/applicability date.

§1.125-7 Cafeteria plan nondiscrimination rules.

(a) Definitions.

(b) Nondiscrimination as to eligibility.

(c) Nondiscrimination as to contributions and benefits.

(d) Key employees.

(e) Section 125(g)(2) safe harbor for cafeteria plans providing health benefits.

(f) Safe harbor test for premium-only-plans.

(g) Permissive disaggregation for nondiscrimination testing.

(h) Optional aggregation of plans for nondiscrimination testing.

(i) Employees of certain controlled groups.

(j) Time to perform nondiscrimination testing.

(k) Discrimination in actual operation prohibited.

(l) Anti-abuse rule.

(m) Tax treatment of benefits in a cafeteria plan.

(n) Employer contributions to employees' Health Savings Accounts.

(o) Effective/applicability date. [Reg. §1.125-0.]

PROP-REG, 2007FED ¶7321, §1.125-1., **Cafeteria plans; general rules, REG-142695-05, 8/6/2007.**

Cafeteria plans; general rules, REG-142695-05, 8/6/2007.

(a) ***Definitions*. —**The definitions set forth in this paragraph (a) apply for purposes of section 125 and the regulations.

(1) The term *cafeteria plan* means a separate written plan that complies with the requirements of section 125 and the regulations, that is maintained by an employer for the benefit of its employees and that is operated in compliance with the requirements of section 125 and the regulations. All participants in a cafeteria plan must be employees. A cafeteria plan must offer at least one permitted taxable benefit (as defined in paragraph (a)(2) of this section) and at least one qualified benefit (as defined in paragraph (a)(3) of this section). A cafeteria plan must not provide for deferral of compensation (except as specifically permitted in paragraph (o) of this section).

(2) The term *permitted taxable benefit* means cash and certain other taxable benefits treated as cash for purposes of section 125. For purposes of section 125, *cash* means cash compensation (including salary reduction), payments for annual leave, sick leave, or other paid time off and severance pay. A distribution from a trust described in section 401(a) is not cash for purposes of section 125. *Other taxable benefits treated as cash* for purposes of section 125 are:

(i) Property;

(ii) Benefits attributable to employer contributions that are currently taxable to the employee upon receipt by the employee; and

(iii) Benefits purchased with after-tax employee contributions, as described in paragraph (h) of this section.

(3) ***Qualified benefit*. —**Except as otherwise provided in section 125(f) and paragraph (q) of this section, the term *qualified benefit* means any benefit attributable to employer contributions to the extent that such benefit is not currently taxable to the employee by reason of an express provision of the Internal Revenue Code (Code) and which does not defer compensation (except as provided in paragraph (o) of this section). The following benefits are qualified benefits that may be offered under a cafeteria plan and are excludible from employees' gross income when provided in accordance with the applicable provisions of the Code —

(A) Group-term life insurance on the life of an employee in an amount that is less than or equal to the $50,000 excludible from gross income under section 79(a), but not combined with any permanent benefit within the meaning of §1.79-0;

(B) An accident and health plan excludible from gross income under section 105 or 106, including self-insured medical reimbursement plans (such as health FSAs described in §1.125-5);

(C) Premiums for COBRA continuation coverage (if excludible under section 106) under the accident and health plan of the employer sponsoring the cafeteria plan or premiums for COBRA continuation coverage of an employee of the employer sponsoring the cafeteria plan under an accident and health plan sponsored by a different employer;

(D) An accidental death and dismemberment insurance policy (section 106);

(E) Long-term or short-term disability coverage (section 106);

(F) Dependent care assistance program (section 129);

(G) Adoption assistance (section 137);

(H) A qualified cash or deferred arrangement that is part of a profit-sharing plan or stock bonus plan, as described in paragraph (o)(3) of this section (section 401(k));

(I) Certain plans maintained by educational organizations (section 125(d)(2)(C) and paragraph (o)(3)(iii) of this section); and

(J) Contributions to Health Savings Accounts (HSAs) (sections 223 and 125(d)(2)(D)).

(4) ***Dependent*. —**The term *dependent* generally means a dependent as defined in section 152. However, the definition of dependent is modified to conform with the underlying Code section for the qualified benefit. For example, for purposes of a benefit under section 105, the term dependent means a dependent as defined in section 152, determined without regard to section 152(b)(1), (b)(2) or (d)(1)(B).

(5) ***Premium-only-plan*. —**A *premium-only-plan* is a cafeteria plan that offers as its sole benefit an election between cash (for example, salary) and payment of the employee share of the employer-provided accident and health insurance premium (excludible from the employee's gross income under section 106).

(b) ***General rules***

(1) ***Cafeteria plans*. —**Section 125 is the exclusive means by which an employer can offer employees an election between taxable and nontaxable benefits without the election itself resulting in inclusion in gross income by the employees. Section 125 provides that cash (including certain taxable benefits) offered to an employee through a nondiscriminatory cafeteria plan is not includible in the employee's gross income merely because the employee has the opportunity to choose among cash and qualified benefits (within the meaning of section 125(e)) through the cafeteria plan. Section 125(a), (d)(1). However, if a plan offering an employee an election between taxable benefits (including cash) and nontaxable qualified benefits does not meet the section 125 requirements, the election between taxable and nontaxable benefits results in gross income to the employee, regardless of what benefit is elected and when the election is made. An employee who has an election among nontaxable benefits and taxable benefits (including cash) that is not through a cafeteria plan that satisfies section 125 must include in gross income the value of the taxable benefit with the greatest value that the employee could have elected to receive, even if the employee elects to receive only the nontaxable benefits offered. The amount of the taxable benefit is includible in the employee's income in the year in which the employee would have actually received the taxable benefit if the employee had elected such benefit. This is the result even if the employee's election between the nontaxable benefits and taxable benefits is made prior to the year in which the employee would actually have received the taxable benefits. See paragraph (q) in §1.125-1 for nonqualified benefits.

(2) ***Nondiscrimination rules for qualified benefits*. —**Accident and health plan coverage, group-term life insurance coverage, and benefits under a dependent care assistance program or adoption assistance program do not fail to be qualified benefits under a cafeteria plan merely because they are includible in gross income because of applicable nondiscrimination requirements (for example, sections 79(d), 105(h),129(d), 137(c)(2)). See also §§1.105-11(k) and 1.125-7.

(3) ***Examples*. —**The following examples illustrate the rules of paragraph (b)(1) of this section.

Example 1. Distributions from qualified pension plan used for health insurance premiums. (i) Employer A maintains a qualified section 401(a) retirement plan for employees. Employer A also provides accident and health insurance (as described in section 106) for employees and former employees, their spouses and dependents. The health insurance premiums are partially paid through a cafeteria plan. None of Employer A's employees are public safety officers. Employer A's health plan allows former employees to elect to have distributions from the qualified retirement plan applied to pay for the health insurance premiums through the cafeteria plan.

(ii) Amounts distributed from the qualified retirement plan which the former employees elect to have applied to pay health insurance premiums through the cafeteria plan are includible in their gross income. The same result occurs if distributions from the qualified retirement plan are applied directly to reimburse section 213(d) medical care expenses incurred by a former employee or his or her spouse or dependents. These distributions are includible in their income, and are not cash for purposes of section 125. The plan is not a cafeteria plan with respect to former employees.

Example 2. Severance pay used to pay COBRA premiums. Employer B maintains a cafeteria plan, which offers employees an election between cash and employer-provided accident and health insurance (excludible from employees' gross income under section 106). Employer B pays terminating employees severance pay. The cafeteria plan also allows a terminating employee to elect between receiving severance pay and using the severance pay to pay the COBRA premiums for the accident and health insurance. These provisions in the cafeteria plan are consistent with the requirements in section 125.

(4) ***Election by participants***

(i) ***In general*. —**A cafeteria plan must offer participants the opportunity to elect between at least one permitted taxable benefit and at least one qualified benefit. For example, if employees are given the opportunity to elect only among two or more nontaxable benefits, the plan is not a cafeteria plan. Similarly, a plan that only offers the election among salary, permitted taxable benefits, paid time off or other taxable benefits is not a cafeteria plan. See section 125(a), (d). See §1.125-2 for rules on elections.

(ii) ***Premium-only-plan*****. —**A cafeteria plan may be a premium-only-plan.

(iii) ***Examples*****. —**The following examples illustrate the rules of paragraph (b)(4)(i) of this section.

Example 1. *No election*. Employer C covers all its employees under its accident and health plan (excludible from employees' gross income under section 106). Coverage is mandatory (that is, employees have no election between cash and the Employer C's accident and health plan). This plan is not a cafeteria plan, because the plan offers employees no election between taxable and nontaxable benefits. The accident and health coverage is excludible from employees' gross income

Example 2. *Election between cash and at least one qualified benefit*. Employer D offers its employees a plan with an election between cash and an employer-provided accident and health plan (excludible from employees' gross income under section 106). If the plan also satisfies all the other requirements of section 125, the plan is a cafeteria plan because it offers an election between at least one taxable benefit and at least one nontaxable qualified benefit.

Example 3. *Election between employer flex-credits and qualified benefits*. Employer E offers its employees an election between an employer flex-credit (as defined in paragraph (b) in §1.125-5) and qualified benefits. If an employee does not elect to apply the entire employer flex-credit to qualified benefits, the employee will receive no cash or other taxable benefit for the unused employer flex-credit. The plan is not a cafeteria plan because it does not offer an election between at least one taxable benefit and at least one nontaxable qualified benefit.

Example 4. *No election between cash and qualified benefits for certain employees*. (i) Employer F maintains a calendar year plan offering employer-provided accident and health insurance coverage which includes employee-only and family coverage options.

(ii) The plan provides for an automatic enrollment process when a new employee is hired, or during the annual election period under the plan: only employees who certify that they have other health coverage are permitted to elect to receive cash. Employees who cannot certify are covered by the accident and health insurance on a mandatory basis. Employer F does not otherwise request or collect information from employees regarding other health coverage as part of the enrollment process. If the employee has a spouse or child, the employee can elect between cash and family coverage.

(iii) When an employee is hired, the employee receives a notice explaining the plan's automatic enrollment process. The notice includes the salary reduction amounts for employee-only coverage and family coverage, procedures for certifying whether the employee has other health coverage, elections for family coverage, information on the time by which a certification or election must be made, and the period for which a certification or election will be effective. The notice is also given to each current employee before the beginning of each plan year, (except that the notice for a current employee includes a description of the employee's existing coverage, if any).

(iv) For a new employee, an election to receive cash or to have family coverage is effective if made when the employee is hired. For a current employee, an election is effective if made prior to the start of each calendar year or under any other circumstances permitted under §1.125-4. An election for any prior year carries over to the next succeeding plan year unless changed. Certification that the employee has other health coverage must be made annually.

(v) Contributions used to purchase employer-provided accident and health coverage under section 125 are not includible in an employee's gross income if the employee can elect cash. Section 125 does not apply to the employee-only coverage of an employee who cannot certify that he or she has other health coverage and, therefore, does not have the ability to elect cash in lieu of health coverage.

(5) ***No deferred compensation*****. —**Except as provided in paragraph (o) of this section, in order for a plan to be a cafeteria plan, the qualified benefits and the permitted taxable benefits offered through the cafeteria plan must not defer compensation. For example, a cafeteria plan may not provide for retirement health benefits for current employees beyond the current plan year or group-term life insurance with a permanent benefit, as defined under §1.79-0.

(c) ***Written plan requirements***

(1) ***General rule*****. —**A cafeteria plan must contain in writing the information described in this paragraph (c), and depending on the qualified benefits offered in the plan, may also be required to contain additional information described in paragraphs (c)(2) and (c)(3) of this section. The cafeteria plan must be adopted and effective on or before the first day of the cafeteria plan year to which it relates. The terms of the plan must apply uniformly to all participants. The cafeteria plan document may be comprised of multiple documents. The written cafeteria plan must contain all of the following information —

(i) A specific description of each of the benefits available through the plan, including the periods during which the benefits are provided (the periods of coverage);

(ii) The plan's rules governing participation, and specifically requiring that all participants in the plan be employees;

(iii) The procedures governing employees' elections under the plan, including the period when elections may be made, the periods with respect to which elections are effective, and providing that elections are irrevocable, except to the extent that the optional change in status rules in §1.125-4 are included in the cafeteria plan;

(iv) The manner in which employer contributions may be made under the plan, (for example, through an employee's salary reduction election or by nonelective employer contributions (that is, flex-credits, as defined in paragraph (b) in §1.125-5) or both);

(v) The maximum amount of employer contributions available to any employee through the plan, by stating:

(A) The maximum amount of elective contributions (i.e., salary reduction) available to any employee through the plan, expressed as a maximum dollar amount or a maximum percentage of compensation or the method for determining the maximum dollar amount; and

(B) For contributions to section 401(k) plans, the maximum amount of elective contributions available to any employee through the plan, expressed as a maximum dollar amount or maximum percentage of compensation that may be contributed as elective contributions through the plan by employees.

(vi) The plan year of the cafeteria plan;

(vii) If the plan offers paid time off, the required ordering rule for use of nonelective and elective paid time off in paragraph (o)(4) of this section;

(viii) If the plan includes flexible spending arrangements (as defined in §1.125-5(a)), the plan's provisions complying with any additional requirements for those FSAs (for example, the uniform coverage rule and the use-or-lose rules in paragraphs (d) and (c) in §1.125-5);

(ix) If the plan includes a grace period, the plan's provisions complying with paragraph (e) of this section; and

(x) If the plan includes distributions from a health FSA to employees' HSAs, the plan's provisions complying with paragraph (n) in §1.125-5.

(2) ***Additional requirements under sections 105(h), 129, and 137.*** **—**A written plan is required for self-insured medical reimbursement plans (§1.105-11(b)(1)(i)), dependent care assistance programs (section 129(d)(1)), and adoption assistance (section 137(c)). Any of these plans or programs offered through a cafeteria plan that satisfies the written plan requirement in this paragraph (c) for the benefits under these plans and programs also satisfies the written plan requirements in §1.105-11(b)(1)(i), section 129(d)(1), and section 137(c) (whichever is applicable). Alternatively, a self-insured medical reimbursement plan, a dependent care assistance program, or an adoption assistance program is permitted to satisfy the requirements in §1.105-11(b)(1)(i), section 129(d)(1), or section 137(c) (whichever is applicable) through a separate written plan, and not as part of the written cafeteria plan.

(3) ***Additional requirements under section 401(k).*** **—**See §1.401(k)-1(e)(7) for additional requirements that must be satisfied in the written plan if the plan offers deferrals into a section 401(k) plan.

(4) ***Cross-reference allowed.*** **—**In describing the benefits available through the cafeteria plan, the written cafeteria plan need not be self-contained. For example, the written cafeteria plan may incorporate by reference benefits offered through other *separate written plans*, such as a section 401(k) plan, or coverage under a dependent care assistance program (section 129), without describing in full the benefits established through these other plans. But, for example, if the cafeteria plan offers different maximum levels of coverage for dependent care assistance programs, the descriptions in the separate written plan must specify the available maximums.

(5) ***Amendments to cafeteria plan.*** **—**Any amendment to the cafeteria plan must be in writing. A cafeteria plan is permitted to be amended at any time during a plan year. However, the amendment is only permitted to be effective for periods after the later of the adoption date or effective date of the amendment. For an amendment adding a new benefit, the cafeteria plan must pay or reimburse only those expenses for new benefits incurred after the later of the amendment's adoption date or effective date.

(6) ***Failure to satisfy written plan requirements.*** **—**If there is no written cafeteria plan, or if the written plan fails to satisfy any of the requirements in this paragraph (c) (including cross-referenced requirements), the plan is not a cafeteria plan and an employee's election between taxable and nontaxable benefits results in gross income to the employee.

(7) ***Operational failure***

(i) ***In general.*** **—**If the cafeteria plan fails to operate according to its written plan or otherwise fails to operate in compliance with section 125 and the regulations, the plan is not a cafeteria plan and employees' elections between taxable and nontaxable benefits result in gross income to the employees.

(ii) ***Failure to operate according to written cafeteria plan or section 125.*** **—**Examples of failures resulting in section 125 not applying to a plan include the following —

(A) Paying or reimbursing expenses for qualified benefits incurred before the later of the adoption date or effective date of the cafeteria plan, before the beginning of a period of coverage or before the later of the date of adoption or effective date of a plan amendment adding a new benefit;

(B) Offering benefits other than permitted taxable benefits and qualified benefits;

(C) Operating to defer compensation (except as permitted in paragraph (o) of this section);

(D) Failing to comply with the uniform coverage rule in paragraph (d) in §1.125-5;

(E) Failing to comply with the use-or-lose rule in paragraph (c) in §1.125-5;

(F) Allowing employees to revoke elections or make new elections, except as provided in §1.125-4 and paragraph (a) in §1.125-2;

(G) Failing to comply with the substantiation requirements of §1.125-6;

(H) Paying or reimbursing expenses in an FSA other than expenses expressly permitted in paragraph (h) in §1.125-5;

(I) Allocating experience gains other than as expressly permitted in paragraph (o) in §1.125-5;

(J) Failing to comply with the grace period rules in paragraph (e) of this section; or

(K) Failing to comply with the qualified HSA distribution rules in paragraph (n) in §1.125-5.

(d) ***Plan year requirements***

(1) ***Twelve consecutive months*****. —**The plan year must be specified in the cafeteria plan. The plan year of a cafeteria plan must be twelve consecutive months, unless a short plan year is allowed under this paragraph (d). A plan year is permitted to begin on any day of any calendar month and must end on the preceding day in the immediately following year (for example, a plan year that begins on October 15, 2007, must end on October 14, 2008). A calendar year plan year is a period of twelve consecutive months beginning on January 1 and ending on December 31 of the same calendar year. A plan year specified in the cafeteria plan is effective for the first plan year of a cafeteria plan and for all subsequent plan years, unless changed as provided in paragraph (d)(2) of this section.

(2) ***Changing plan year*****. —**The plan year is permitted to be changed only for a valid business purpose. A change in the plan year is not permitted if a principal purpose of the change in plan year is to circumvent the rules of section 125 or these regulations. If a change in plan year does not satisfy this subparagraph, the attempt to change the plan year is ineffective and the plan year of the cafeteria plan remains the same.

(3) ***Short plan year*****. —**A short plan year of less than twelve consecutive months is permitted for a valid business purpose.

(4) ***Examples*****. —**The following examples illustrate the rules in paragraph (d) of this section:

Example 1. Employer with calendar year. Employer G, with a calendar taxable year, first establishes a cafeteria plan effective July 1, 2009. The cafeteria plan specifies a calendar plan year. The first cafeteria plan year is the period beginning on July 1, 2009, and ending on December 31, 2009. Employer G has a business purpose for a short first cafeteria plan year.

Example 2. Employer changes insurance carrier. Employer H establishes a cafeteria plan effective January 1, 2009, with a calendar year plan year. The cafeteria plan offers an accident and health plan through Insurer X. In March 2010, Employer H contracts to provide accident and health insurance through another insurance company, Y. Y's accident and health insurance is offered on a July 1-June 30 benefit year. Effective July 1, 2010, Employer H amends the plan to change to a July 1-June 30 plan year. Employer H has a business purpose for changing the cafeteria plan year and for the short plan year ending June 30, 2010.

(5) ***Significance of plan year*****. —**The plan year generally is the coverage period for benefits provided through the cafeteria plan to which annual elections for these benefits apply. Benefits elected pursuant to the employee's election for a plan year generally may not be carried forward to subsequent plan years. However, see the grace period rule in paragraph (e) of this section.

(e) ***Grace period***

(1) ***In general*****. —**A cafeteria plan may, at the employer's option, include a grace period of up to the fifteenth day of the third month immediately following the end of each plan year. If a cafeteria plan provides for a grace period, an employee who has unused benefits or contributions relating to a qualified benefit (for example, health flexible spending arrangement (health FSA) or dependent care assistance) from the immediately preceding plan year, and who incurs expenses for that same qualified benefit during the grace period, may be paid or reimbursed for those expenses from the unused benefits or contributions as if the expenses had been incurred in the immediately preceding plan year. A grace period is available for all qualified benefits described in paragraph (a)(3) of this section, except that the grace period does not apply to paid time off and elective contributions under a section 401(k) plan. The effect of the grace period is that the employee may have as long as 14 months and 15 days (that is, the 12 months in the current cafeteria plan year plus the grace period) to use the benefits or contributions for a plan year before those amounts are *forfeited* under the *use-or-lose* rule in paragraph (c) in §1.125-5. If the grace period is added to a cafeteria plan through an amendment, all requirements in paragraph (c) of this section must be satisfied.

(2) ***Grace period optional features*****. —**A grace period provision may contain any or all of the following —

(i) The grace period may apply to some qualified benefits described in paragraph (a)(3) of this section, but not to others;

(ii) The grace period provision may limit the amount of unused benefits or contributions available during the grace period. The limit must be uniform and apply to all participants. However, the limit must not be based on a percentage of the amount of the unused benefits or contributions remaining at the end of the immediately prior plan year;

(iii) The last day of the grace period may be sooner than the fifteenth day of the third month immediately following the end of the plan year (that is, the grace period may be shorter than two and one half months);

(iv) The grace period provision is permitted to treat expenses for qualified benefits incurred during the grace period either as expenses incurred during the immediately preceding plan year or as expenses incurred during the current plan year (for example, the plan may first apply the unused contributions or benefits from the immediately preceding year to pay or reimburse grace period expenses and then, when the unused contributions and benefits from the prior year are exhausted, the grace period expenses may be paid from current year contributions and benefits.); and

(v) The grace period provision may permit the employer to defer the allocation of expenses described in paragraph (e)(2)(iv) of this section until after the end of the grace period.

(3) ***Grace period requirements*****. —**A grace period must satisfy the requirements in paragraph (c) of this section and all of the following requirements:

(i) The grace period provisions in the cafeteria plan (including optional provisions in paragraph (e)(2) of this section) must apply uniformly to all participants in the cafeteria plan, determined as of the last day of the plan year. Participants in the cafeteria plan through COBRA and participants who were participants as of the last day of the plan year but terminate during the grace period are participants for purposes of the grace period. See §54.4980B-2, Q & A-8 of this chapter;

(ii) The grace period provision in the cafeteria plan must state that unused benefits or contributions relating to a particular qualified benefit may only be used to pay or reimburse expenses incurred with respect to the same qualified benefit. For example, unused amounts elected to pay or reimburse medical expenses in a health FSA may not be used to pay or reimburse dependent care expenses incurred during the grace period; and

(iii) The grace period provision in the cafeteria plan must state that to the extent any unused benefits or contributions from the immediately preceding plan year exceed the expenses for the qualified benefit incurred during the grace period, those remaining unused benefits or contributions may not be carried forward to any subsequent period (including any subsequent plan year), cannot be cashed-out and must be forfeited under the use-or-lose rule. See paragraph (c) in §1.125-5

(4) ***Examples*. —**The following examples illustrate the rules in this paragraph (e).

Example 1. *Expenses incurred during grace period and immediately following plan year*. (i) Employer I's calendar year cafeteria plan includes a grace period allowing all participants to apply unused benefits or contributions remaining at the end of the plan year to qualified benefits incurred during the grace period immediately following that plan year. The grace period for the plan year ending December 31, 2009, ends on March 15, 2010.

(ii) Employee X timely elected salary reduction of $1,000 for a health FSA for the plan year ending December 31, 2009. As of December 31, 2009, X has $200 remaining unused in his health FSA. X timely elected salary reduction for a health FSA of $1,500 for the plan year ending December 31, 2010.

(iii) During the grace period from January 1 through March 15, 2010, X incurs $300 of unreimbursed medical expenses (as defined in section 213(d)). The unused $200 from the plan year ending December 31, 2009, is applied to pay or reimburse $200 of X's $300 of medical expenses incurred during the grace period. Therefore, as of March 16, 2010, X has no unused benefits or contributions remaining for the plan year ending December 31, 2009.

(iv) The remaining $100 of medical expenses incurred between January 1 and March 15, 2010, is paid or reimbursed from X's health FSA for the plan year ending December 31, 2010. As of March 16, 2010, X has $1,400 remaining in the health FSA for the plan year ending December 31, 2010.

Example 2. *Unused benefits exceed expenses incurred during grace period*. Same facts as *Example 1*, except that X incurs $150 of section 213(d) medical expenses during the grace period (January 1 through March 15, 2010). As of March 16, 2010, X has $50 of unused benefits or contributions remaining for the plan year ending December 31, 2009. The unused $50 cannot be cashed-out, converted to any other taxable or nontaxable benefit, or used in any other plan year (including the plan year ending December 31, 2009). The unused $50 is subject to the use-or-lose rule in paragraph (c) in §1.125-5 and is forfeited. As of March 16, 2010, X has the entire $1,500 elected in the health FSA for the plan year ending December 31, 2010.

Example 3. *Terminated participants*. (i) Employer J's cafeteria plan includes a grace period allowing all participants to apply unused benefits or contributions remaining at the end of the plan year to qualified benefits incurred during the grace period immediately following that plan year. For the plan year ending on December 31, 2009, the grace period ends March 15, 2010.

(ii) Employees A, B, C, and D each timely elected $1,200 salary reduction for a health FSA for the plan year ending December 31, 2009. Employees A and B terminated employment on September 15, 2009. Each has $500 of unused benefits or contributions in the health FSA.

(iii) Employee A elected COBRA for the health FSA. Employee A is a participant in the cafeteria plan as of December 31, 2009, the last day of the 2009 plan year. Employee A has $500 of unused benefits or contributions available during the grace period for the 2009 plan year (ending March 15, 2010).

(iv) Employee B did not elect COBRA for the health FSA. Employee B is not a participant in the cafeteria plan as of December 31, 2009. The grace period does not apply to Employee B.

(v) Employee C has $500 of unused benefits in his health FSA as of December 31, 2009, and terminated employment on January 15, 2010. Employee C is a participant in the cafeteria plan as of December 31, 2009 and has $500 of unused benefits or contributions available during the grace period ending March 15, 2010, even though he terminated employment on January 15, 2010.

(vi) Employee D continues to work for Employer H throughout 2009 and 2010, also has $500 of unused benefits or contributions in his health FSA as of December 31, 2009, but made no health FSA election for 2010. Employee D is a participant in the cafeteria plan as of December 31, 2009 and has $500 of unused benefits or contributions available during the grace period ending March 15, 2010, even though he is not a participant in a health FSA for the 2010 plan year.

(f) ***Run-out period*. —**A cafeteria plan is permitted to contain a run-out period as designated by the employer. A run-out period is a period after the end of the plan year (or grace period) during which a participant can submit a claim for reimbursement for a qualified benefit incurred during the plan year (or grace period). Thus, a plan is also permitted to provide a deadline on or after the end of the plan year (or grace period) for submitting a claim for reimbursement for the plan year. Any run-out period must be provided on a uniform and consistent basis with respect to all participants.

(g) ***Employee for purposes of section 125***

(1) ***Current employees, former employees*. —**The term employee includes any current or former employee (including any laid-off employee or retired employee) of the employer. See paragraph (g)(3) of this section concerning limits on participation by former employees. Specifically, the term *employee* includes the following —

(i) Common law employee;

(ii) Leased employee described in section 414(n);

(iii) Full-time life insurance salesman (as defined in section 7701(a)(20)); and

(iv) A current employee or former employee described in paragraphs (g)(1)(i) through (iii) of this section.

(2) ***Self-employed individual not an employee***

(i) ***In general.*** **—**The term *employee* does not include a self-employed individual or a 2-percent shareholder of an S corporation, as defined in paragraph (g)(2)(ii) of this subsection. For example, a sole proprietor, a partner in a partnership, or a director solely serving on a corporation's board of directors (and not otherwise providing services to the corporation as an employee) is not an employee for purposes of section 125, and thus is not permitted to participate in a cafeteria plan. However, a sole proprietor may sponsor a cafeteria plan covering the sole proprietor's employees (but not the sole proprietor). Similarly, a partnership or S corporation may sponsor a cafeteria plan covering employees (but not a partner or 2-percent shareholder of an S corporation).

(ii) ***Two percent shareholder of an S corporation*****. —**A 2-percent shareholder of an S corporation has the meaning set forth in section 1372(b).

(iii) ***Certain dual status individuals.*** **—**If an individual is an employee of an employer and also provides services to that employer as an independent contractor or director (for example, an individual is both a director and an employee of a C corp), the individual is eligible to participate in that employer's cafeteria plan solely in his or her capacity as an employee. This rule does not apply to partners or to 2-percent shareholders of an S corporation.

(iv) ***Examples.*** **—**The following examples illustrate the rules in paragraphs (g)(2)(ii) and (g)(2)(iii) of this section:

Example 1. Two-percent shareholders of an S corporation. (i) Employer K, an S corporation, maintains a cafeteria plan for its employees (other than 2-percent shareholders of an S corporation). Employer K's taxable year and the plan year are the calendar year. On January 1, 2009, individual Z owns 5 percent of the outstanding stock in Employer K. Y, who owns no stock in Employer K, is married to Z. Y and Z are employees of Employer K. Z is a 2-percent shareholder in Employer K (as defined in section 1372(b)). Y is also a 2-percent shareholder in Employer K by operation of the attribution rules in section 318(a)(1)(A)(i).

(ii) On July 15, 2009, Z sells all his stock in Employer K to an unrelated third party, and ceases to be a 2-percent shareholder. Y and Z continue to work as employees of Employer K during the entire 2009 calendar year. Y and Z are ineligible to participate in Employer K's cafeteria plan for the 2009 plan year.

Example 2. Director and employee. T is an employee and also a director of Employer L, a C corp that sponsors a cafeteria plan. The cafeteria plan allows only employees of Employer L to participate in the cafeteria plan. T's annual compensation as an employee is $50,000; T is also paid $3,000 annually in director's fees. T makes a timely election to salary reduce $5,000 from his employee compensation for dependent care benefits. T makes no election with respect to his compensation as a director. T may participate in the cafeteria plan in his capacity as an employee of Employer L.

(3) ***Limits on participation by former employees.*** **—**Although former employees are treated as employees, a cafeteria plan may not be established or maintained predominantly for the benefit of former employees of the employer. Such a plan is not a cafeteria plan.

(4) ***No participation by the spouse or dependent of an employee***

(4) ***Benefits allowed to participant's spouse or dependents but not participation*****. —**The spouse or dependents of employees may not be participants in a cafeteria plan unless they are also employees. However, a cafeteria plan may provide benefits to spouses and dependents of participants. For example, although an employee's spouse may benefit from the employee's election of accident and health insurance coverage or of coverage through a dependent care assistance program, the spouse may not participate in a cafeteria plan (that is, the spouse may not be given the opportunity to elect or purchase benefits offered by the plan).

(ii) ***Certain elections after employee's death*****. —**An employee*'s* spouse is not a participant in a cafeteria plan merely because the spouse has the right, upon the death of the employee, to elect among various settlement options or to elect among permissible distribution options with respect to the deceased employee's benefits through a section 401(k) plan, Health Savings Account, or certain group-term life insurance offered through the cafeteria plan. See §54.4980B-2, Q & A 8 and §54.4980B-4, Q & A-1 of this chapter on COBRA rights of a participant's spouse or dependents.

(5) ***Employees of certain controlled groups*****. —**All employees who are treated as employed by a single employer under section 414(b), (c), (m), or (o) are treated as employed by a single employer for purposes of section 125. Section 125(g)(4); section 414(t).

(h) ***After-tax employee contributions***

(1) ***Certain after-tax employee contributions treated as cash*****. —**In addition to the cash benefits described in paragraph (a)(2) of this section*,* in general, a benefit is treated as cash for purposes of section 125 if the benefit does not defer compensation (except as provided in paragraph (o) of this section) and an employee who receives the benefit purchases such benefit with after-tax employee contributions or is treated, for all purposes under the Code (including, for example, reporting and withholding purposes), as receiving, at the time that the benefit is received, cash compensation equal to the full value of the benefit at that time and then purchasing the benefit with after-tax employee contributions. Thus, for example, long-term disability coverage is treated as cash for purposes of section 125 if the cafeteria plan provides that an employee may purchase the coverage through the cafeteria plan with after-tax employee contributions or provides that the employee receiving such coverage is treated as having received cash compensation equal to the value of the coverage and then as having purchased the coverage with after-tax employee contributions. Also, for example, a cafeteria plan may offer employees the opportunity to purchase, with after-tax employee contributions, group-term life insurance on the life of an employee (providing no permanent benefits), an accident and health plan, or a dependent care assistance program.

(2) ***Accident and health coverage purchased for someone other than the employee's spouse or dependents with after-tax employee contributions*****. —**If the requirements of section 106 are satisfied, employer-provided accident and health coverage for an employee and his or her spouse or dependents is excludible from the employee's gross income. The fair market value of coverage for any other individual, provided with respect to the employee, is includible in the employee's gross income. §1.106-1; §1.61-21(a)(4), and §1.61-21(b)(1). A cafeteria plan is permitted to allow employees to elect accident and health coverage for an individual who is not the spouse or dependent of the employee as a taxable benefit.

(3) ***Example.*** **—**The following example illustrates the rules of this paragraph (h):

Example. *Accident and health plan coverage for individuals who are not a spouse or dependent of an employee*. (i) Employee C participates in Employer M's cafeteria plan. Employee C timely elects salary reduction for employer-provided accident and health coverage for himself and for accident and health coverage for his former spouse. C's former spouse is not C's dependent. A former spouse is not a spouse as defined in section 152.

(ii) The fair market value of the coverage for the former spouse is $1,000. Employee C has $1,000 includible in gross income for the accident and health coverage of his former spouse, because the section 106 exclusion applies only to employer-provided accident and health coverage for the employee or the employee's spouse or dependents.

(iii) No payments or reimbursements received under the accident and health coverage result in gross income to Employee C or to the former spouse. The result is the same if the $1,000 for coverage of C's former spouse is paid from C's after-tax income outside the cafeteria plan.

(i) ***Prohibited taxable benefits*. —**Any taxable benefit not described in paragraph (a)(2) of this section and not treated as cash for purposes of section 125 in paragraph (h) of this section is not permitted to be included in a cafeteria plan. A plan that offers taxable benefits other than the taxable benefits described in paragraph (a)(2) and (h) of this section is not a cafeteria plan.

(j) ***Coordination with other rules***

(1) ***In general*. —**If a benefit is excludible from an employee's gross income when provided separately, the benefit is excludible from gross income when provided through a cafeteria plan. Thus, a qualified benefit is excludible from gross income if both the rules under section 125 and the specific rules providing for the exclusion of the benefit from gross income are satisfied. For example, if the nondiscrimination rules for specific qualified benefits (for example, sections 79(d), 105(h), 129(d)(2), 137(c)(2)) are not satisfied, those qualified benefits are includible in gross income. Thus, if $50,000 in group-term life insurance is offered through a cafeteria plan, the nondiscrimination rules in section 79(d) must be satisfied in order to exclude the coverage from gross income.

(2) ***Section 125 nondiscrimination rules*. —**Qualified benefits are includible in the gross income of highly compensated participants or key employees if the nondiscrimination rules of section 125 are not satisfied. See §1.125-7.

(3) ***Taxable benefits*. —**If a benefit that is includible in gross income when offered separately is offered through a cafeteria plan, the benefit continues to be includible in gross income.

(k) ***Group-term life insurance***

(1) ***In general*. —**In addition to offering up to $50,000 in group-term life insurance coverage excludible under section 79(a), a cafeteria plan may offer coverage in excess of that amount. The cost of coverage in excess of $50,000 in group-term life insurance coverage provided under a policy or policies carried directly or indirectly by one or more employers (taking into account all coverage provided both through a cafeteria plan and outside a cafeteria plan) is includible in an employee's gross income. Group-term life insurance combined with permanent benefits, within the meaning of §1.79-0, is a prohibited benefit in a cafeteria plan.

(2) ***Determining cost of insurance includible in employee's gross income***

(i) ***In general*. —**If the aggregate group-term life insurance coverage on the life of the employee (under policies carried directly or indirectly by the employer) exceeds $50,000, all or a portion of the insurance is provided through a cafeteria plan, and the group-term life insurance is provided through a plan that meets the nondiscrimination rules of section 79(d), the amount includible in an employee's gross income is determined under paragraphs (k)(2)(i)(A) through (C) of this section. For each employee —

(A) The entire amount of salary reduction and employer flex-credits through a cafeteria plan for group-term life insurance coverage on the life of the employee is excludible from the employee's gross income, regardless of the amount of employer-provided group-term life insurance on the employee's life (that is, whether or not the coverage provided to the employee both through the cafeteria plan and outside the cafeteria plan exceeds $50,000);

(B) The cost of the group-term life insurance in excess of $50,000 of coverage is includible in the employee's gross income. The amount includible in the employee's income is determined using the rules of §1.79-3 and Table I (*Uniform Premiums for $1,000 of Group-Term Life Insurance Protection*). See subparagraph (C) of this paragraph (k)(2)(i) for determining the amount paid by the employee for purposes of reducing the Table I amount includible in income under §1.79-3.

(C) In determining the amount paid by the employee toward the purchase of the group-term life insurance for purposes of §1.79-3, only an employee's after-tax contributions are treated as an amount paid by the employee.

(ii) ***Examples*. —**The rules in this paragraph (k) are illustrated by the following examples, in which the group-term life insurance coverage satisfies the nondiscrimination rules in section 79(d), provides no permanent benefits, is for a 12-month period, is the only group-term life insurance coverage provided under a policy carried directly or indirectly by the employer, and applies Table I (*Uniform Premiums for $1,000 of Group-Term Life Insurance Protection) effective July 1, 1999:*

Example 1. *Excess group-term life insurance coverage provided through salary reduction in a cafeteria plan*. (i) Employer N provides group-term life insurance coverage to its employees only through its cafeteria plan. Employer N's cafeteria plan allows employees to elect salary reduction for group-term life insurance. Employee B, age 42, elected salary reduction of $200 for $150,000 of group-term life insurance. None of the group-term life insurance is paid through after-tax employee contributions.

(ii) B's $200 of salary reduction for group-term life insurance is excludible from B's gross income under paragraph (k)(2)(i)(A).

(iii) B has a total of $150,000 of group-term life insurance. The group-term life insurance in excess of the dollar limitation of section 79 is $100,000 (150,000 - 50,000).

(iv) The Table I cost is $120 for $100,000 of group-term life insurance for an individual between ages 40 to 44. The Table I cost of $120 is reduced by zero (because B paid no portion of the group-term life insurance with after-tax employee contributions), under paragraphs (k)(2)(i)(A)-(B) of this section.

(v) The amount includible in B's gross income for the $100,000 of excess group-term life insurance is $120.

Example 2. Excess group-term life insurance coverage provided through salary reduction in a cafeteria plan where employee purchases a portion of group-term life insurance coverage with after-tax contributions. (i) Same facts as *Example 1*, except that B elected salary reduction of $100 and makes an after-tax contribution of $100 toward the purchase of group-term life insurance coverage.

(ii) B's $100 of salary reduction for group-term life insurance is excludible from B's gross income, under paragraph (k)(2)(i)(A) of this section.

(iii) B has a total of $150,000 of group-term life insurance. The group-term life insurance in excess of the dollar limitation of section 79 is $100,000 (150,000 - 50,000).

(iv) The Table I cost is $120 for $100,000 of group-term life insurance for an individual between ages 40 to 44, under (k)(2)(i)(B). The Table I cost of $120 is reduced by $100 (because B paid $100 for the group-term life insurance with after-tax employee contributions), under paragraphs (k)(2)(i)(B) and (k)(2)(i)(C) of this section.

(v) The amount includible in B's gross income for the $100,000 of excess group-term life insurance coverage is $20.

Example 3. Excess group-term life insurance coverage provided through salary reduction in a cafeteria plan and outside a cafeteria plan. (i) Same facts as *Example 1* except that Employer N also provides (at no cost to employees) group-term life insurance coverage equal to each employee's annual salary. Employee B's annual salary is $150,000. B has $150,000 of group-term life insurance directly from Employer N, and also $150,000 coverage through Employer N's cafeteria plan.

(ii) B's $200 of salary reduction for group-term life insurance is excludible from B's gross income, under paragraph (k)(2)(i)(A) of this section.

(iii) B has a total of $300,000 of group-term life insurance. The group-term life insurance in excess of the dollar limitation of section 79 is $250,000 (300,000 - 50,000).

(iv) The Table I cost is $300 for $250,000 of group-term life insurance for an individual between ages 40 to 44. The Table I cost of $300 is reduced by zero (because B paid no portion of the group-term life insurance with after-tax employee contributions), under paragraphs (k)(2)(i)(B) and (k)(2)(i)(C) of this section.

(v) The amount includible in B's gross income for the $250,000 of excess group-term life insurance is $300.

Example 4. Excess group-term life insurance coverage provided through salary reduction in a cafeteria plan and outside a cafeteria plan. (i) Same facts as *Example 3* except that Employee C's annual salary is $30,000. C has $30,000 of group-term life insurance coverage provided directly from Employer N, and elects an additional $30,000 of coverage for $40 through Employer N's cafeteria plan. C is 42 years old.

(ii) C's $40 of salary reduction for group-term life insurance is excludible from C's gross income, under paragraph (k)(2)(i)(A) of this section.

(iii) C has a total of $60,000 of group-term life insurance. The group-term life insurance in excess of the dollar limitation of section 79 is $10,000 (60,000 - 50,000).

(iv) The Table I cost is $12 for $10,000 of group-term life insurance for an individual between ages 40 to 44. The Table I cost of $12 is reduced by zero (because C paid no portion of the group-term life insurance with after-tax employee contributions), under paragraphs (k)(2)(i)(B) and (k)(2)(i)(C) of this section.

(v) The amount includible in C's gross income for the $10,000 of excess group-term life insurance coverage is $12.

(l) ***COBRA premiums***

(1) ***Paying COBRA premiums through a cafeteria plan*****. —**Under §1.125-4(c)(3)(iv), COBRA premiums for an employer-provided group health plan are qualified benefits if:

(i) The premiums are excludible from an employee's income under section 106; or

(ii) The premiums are for the accident and health plan of the employer sponsoring the cafeteria plan, even if the fair market value of the premiums is includible in an employee's gross income. See also paragraph (e)(2) in §1.125-5 and §54.4980B-2, Q & A-8 of this chapter for COBRA rules for health FSAs.

(2) ***Example*****. —**The following example illustrates the rules of this paragraph (l):

Example. *COBRA premiums*. (i) Employer O maintains a cafeteria plan for full-time employees, offering an election between cash and employer-provided accident and health insurance and other qualified benefits. Employees A, B, and C participate in the cafeteria plan. On July 1, 2009, Employee A has a qualifying event (as defined in §54.4980B-4 of this chapter).

(ii) Employee A was a full-time employee and became a part-time employee and for that reason, is no longer covered by Employer O's accident and health plan. Under §1.125-4(f)(3)(ii), Employee A changes her election to salary reduce to pay her COBRA premiums.

(iii) Employee B previously worked for another employer, quit and elected COBRA. Employee B begins work for Employer O on July 1, 2009, and becomes eligible to participate in Employer O's cafeteria plan on July 1, 2009, but will not be eligible to participate in Employer O's accident and health plan until October 1, 2009. Employee B elects to salary reduce to pay COBRA premiums for coverage under the accident and health plan sponsored by B's former employer.

(iv) Employee C and C's spouse are covered by Employer O's accident and health plan until July 1, 2009, when C's divorce from her spouse became final. C continues to be covered by the accident and health plan. On July 1, 2009, C requests to pay COBRA premiums for her former spouse (who is not C's dependent (as defined in section 152)) with after-tax employee contributions.

(v) Salary reduction elections for COBRA premiums for Employees A and B are qualified benefits for purposes of section 125 and are excludible from the gross income of Employees A and B. Employer O allows A and B to salary reduce for these COBRA premiums.

(vi) Employer O allows C to pay for COBRA premiums for C's former spouse, with after-tax employee contributions because although accident and health coverage for C's former spouse is permitted in a cafeteria plan, the premiums are includible in C's gross income.

(vii) The operation of Employer O's cafeteria plan satisfies the requirements of this paragraph (l).

(m) ***Payment or reimbursement of employees' individual accident and health insurance premiums***

(1) ***In general. —***The payment or reimbursement of employees' substantiated individual health insurance premiums is excludible from employees' gross income under section 106 and is a qualified benefit for purposes of section 125.

(2) ***Example. —***The following example illustrates the rule of this paragraph (m):

Example. *Payment or reimbursement of premiums*. (i) Employer P's cafeteria plan offers the following benefits for employees who are covered by an individual health insurance policy. The employee substantiates the expenses for the premiums for the policy (as required in paragraph (b)(2) in §1.125-6) before any payments or reimbursements to the employee for premiums are made. The payments or reimbursements are made in the following ways:

(ii) The cafeteria plan reimburses each employee directly for the amount of the employee's substantiated health insurance premium;

(iii) The cafeteria plan issues the employee a check payable to the health insurance company for the amount of the employee's health insurance premium, which the employee is obligated to tender to the insurance company;

(iv) The cafeteria plan issues a check in the same manner as (iii), except that the check is payable jointly to the employee and the insurance company; or

(v) Under these circumstances, the individual health insurance policies are accident and health plans as defined in §1.106-1. This benefit is a qualified benefit under section 125.

(n) ***Section 105 rules for accident and health plan offered through a cafeteria plan***

(1) ***General rule. —***In order for an accident and health plan to be a qualified benefit that is excludible from gross income if elected through a cafeteria plan, the cafeteria plan must satisfy section 125 and the accident and health plan must satisfy section 105(b) and (h).

(2) ***Section 105(b) requirements in general. —***Section 105(b) provides an exclusion from gross income for amounts paid to an employee from an employer-funded accident and health plan specifically to reimburse the employee for certain expenses for medical care (as defined in section 213(d)) incurred by the employee or the employee's spouse or dependents during the period for which the benefit is provided to the employee (that is, when the employee is covered by the accident and health plan).

(o) ***Prohibition against deferred compensation***

(1) ***In general.. —***Any plan that offers a benefit that defers compensation (except as provided in this paragraph (o)) is not a cafeteria plan. See section 125(d)(2)(A). A plan that permits employees to carry over unused elective contributions, after-tax contributions, or plan benefits from one plan year to another (except as provided in paragraphs (e), (o)(3) and (4) and (p) of this section) defers compensation. This is the case regardless of how the contributions or benefits are used by the employee in the subsequent plan year (for example, whether they are automatically or electively converted into another taxable or nontaxable benefit in the subsequent plan year or used to provide additional benefits of the same type). Similarly, a cafeteria plan also defers compensation if the plan permits employees to use contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year (for example, life, health or disability if these benefits have a savings or investment feature, such as whole life insurance). See also Q & A-5 in §1.125-3, prohibiting deferring compensation from one cafeteria plan year to a subsequent cafeteria plan year. See paragraph (e) of this section for grace period rules. A plan does not defer compensation merely because it allocates experience gains (or forfeitures) among participants in compliance with paragraph (o) in §1.125-5.

(2) ***Effect if a plan includes a benefit that defers the receipt of compensation or a plan operates to defer compensation. —***If a plan violates paragraph (o)(1) of this section, the availability of an election between taxable and nontaxable benefits under such a plan results in gross income to the employees.

(3) ***Cash or deferred arrangements that may be offered in a cafeteria plan***

(i) ***In general. —***A cafeteria plan may offer the benefits set forth in this paragraph (o)(3), even though these benefits defer compensation.

(ii) ***Elective contributions to a section 401(k) plan. —***A cafeteria plan may permit a covered employee to elect to have the employer, on behalf of the employee, pay amounts as contributions to a trust that is part of a profit-sharing or stock bonus plan or rural cooperative plan (within the meaning of section 401(k)(7)), which includes a qualified cash or deferred arrangement (as defined in section 401(k)(2)). In addition, after-tax employee contributions under a qualified plan subject to section 401(m) are permitted through a cafeteria plan. The right to make such contributions does not cause a plan to fail to be a cafeteria plan merely because, under the qualified plan, employer matching contributions (as defined in section 401(m)(4)(A)) are made with respect to elective or after-tax employee contributions.

(iii) ***Additional permitted deferred compensation arrangements. —***A plan maintained by an educational organization described in section 170(b)(1)(A)(ii) to the extent of amounts which a covered employee may elect to have the employer pay as contributions for post-retirement group life insurance is permitted through a cafeteria plan, if- -

(A) All contributions for such insurance must be made before retirement; and

(B) Such life insurance does not have a cash surrender value at any time.

(iv) ***Contributions to HSAs.*** **—**Contributions to covered employees' HSAs as defined in section 223 (but not contributions to Archer MSAs).

(4) ***Paid time off***

(i) ***In general..*** **—**A cafeteria plan is permitted to include elective paid time off (that is, vacation days, sick days or personal days) as a permitted taxable benefit through the plan by permitting employees to receive more paid time off than the employer otherwise provides to the employees on a nonelective basis, but only if the inclusion of elective paid time off through the plan does not operate to permit the deferral of compensation. In addition, a plan that only offers the choice of cash or paid time off is not a cafeteria plan and is not subject to the rules of section 125. In order to avoid deferral of compensation, the cafeteria plan must preclude any employee from using the paid time off or receiving cash, in a subsequent plan year, for any portion of such paid time off remaining unused as of the end of the plan year. (See paragraph (o)(4)(iii) of this section for the deadline to cash out unused elective paid time off.) For example, a plan that offers employees the opportunity to purchase paid time off (or to receive cash or other benefits through the plan in lieu of paid time off) is not a cafeteria plan if employees who purchase the paid time off for a plan year are allowed to use any unused paid time off in a subsequent plan year. This is the case even though the plan does not permit the employee to convert, in any subsequent plan year, the unused paid time off into any other benefit.

(ii) ***Ordering of elective and nonelective paid time off..*** **—**In determining whether a plan providing paid time off operates to permit the deferral of compensation, a cafeteria plan must provide that employees are deemed to use paid time off in the following order:

(A) ***Nonelective paid time off.*** **—**Nonelective paid time off (that is, paid time off with respect to which the employee has no election) is used first;

(B) ***Elective paid time off.*** **—**Elective paid time off is used after all nonelective paid time off is used.

(iii) ***Cashing out or forfeiture of unused elective paid time off, in general.*** **—**The cafeteria plan must provide that all unused elective paid time off (determined as of the last day of the plan year) must either be paid in cash (within the time specified in this paragraph (o)(4)) or be forfeited. This provision must apply uniformly to all participants in the cafeteria plan.

(A) ***Cash out of unused elective paid time off.*** **—**A plan does not operate to permit the deferral of compensation merely because the plan provides that an employee who has not used all elective paid time off for a plan year receives in cash the value of such unused paid time off. The employee must receive the cash on or before the last day of the cafeteria plan's plan year to which the elective contributions used to purchase the unused elective paid time off relate.

(B) ***Forfeiture of unused elective paid time off.*** **—**If the cafeteria plan provides for forfeiture of unused elective paid time off, the forfeiture must be effective on the last day of the plan year to which the elective contributions relate.

(iv) ***No grace period for paid time off.*** **—**The grace period described in paragraph (e) of this section does not apply to paid time off.

(v) ***Examples..*** **—**The following examples illustrate the rules of this paragraph (o)(4):

Example 1.Plan cashes out unused elective paid time off on or before the last day of the plan year. (i) Employer Q provides employees with two weeks of paid time off for each calendar year. Employer Q's human resources policy (that is, outside the cafeteria plan), permits employees to carry over one nonelective week of paid time off to the next year. Employer Q maintains a calendar year cafeteria plan that permits the employee to purchase, with elective contributions, an additional week of paid time off.

(ii) For the 2009 plan year, Employee A (with a calendar tax year), timely elects to purchase one additional week of paid time off. During 2009, Employee A uses only two weeks of paid time off. Employee A is deemed to have used two weeks of nonelective paid time off and zero weeks of elective paid time off.

(iii) Pursuant to the cafeteria plan, the plan pays Employee A the value of the unused elective paid time off week in cash on December 31, 2009. Employer Q includes this amount on the 2009 Form W-2 for Employee A. This amount is included in Employee A's gross income in 2009. The cafeteria plan's terms and operations do not violate the prohibition against deferring compensation.

Example 2.Unused nonelective paid time off carried over to next plan year. (i) Same facts as *Example 1*, except that Employee A uses only one week of paid time off during the year. Pursuant to the cafeteria plan, Employee A is deemed to have used one nonelective week, and having retained one nonelective week and one elective week of paid time off. Employee A receives in cash the value of the unused elective paid time off on December 31, 2009. Employer Q includes this amount on the 2009 Form W-2 for Employee A. Employee A must report this amount as gross income in 2009.

(ii) Pursuant to Employer Q's human resources policy, Employee A is permitted to carry over the one nonelective week of paid time off to the next year. Nonelective paid time off is not part of the cafeteria plan (that is, neither Employer Q nor the cafeteria plan permit employees to exchange nonelective paid time off for other benefits).

(iii) The cafeteria plan's terms and operations do not violate the prohibition against deferring compensation.

Example 3. Forfeiture of unused elective paid time off. Same facts as *Example 2*, except that pursuant to the cafeteria plan, Employee A forfeits the remaining one week of elective paid time off. The cafeteria plan's terms and operations do not violate the prohibition against deferring compensation.

Example 4. Unused elective paid time off carried over to next plan year. Same facts as *Example 1*, except that Employee A uses only two weeks of paid time off during the 2009 plan year, and, under the terms of the cafeteria plan, Employee A is treated as having used the two nonelective weeks and as having retained the one elective week. The one remaining week (that is, the elective week) is carried over to the next plan year (or the value thereof used for any other purpose in the next plan year). The plan operates to permit deferring compensation and is not a cafeteria plan.

Example 5. Paid time off exchanged for accident and health insurance premiums. Employer R provides employees with four weeks of paid time off for a year. Employer R's calendar year cafeteria plan permits employees to exchange up to one week of paid time off to pay the employee's share of accident and health insurance premiums. For the 2009 plan year, Employee B (with a calendar tax year), timely elects to exchange one week of paid time off (valued at $769) to pay accident and health insurance premiums for 2009. The $769 is excludible from Employee B's gross income under section 106. The cafeteria plan's terms and operations do not violate the prohibition against deferring compensation.

(p) ***Benefits relating to more than one year***

(1) ***Benefits in an accident and health insurance policy relating to more than one year. —***Consistent with section 125(d), an accident and health insurance policy may include certain benefits, as set forth in this paragraph (p)(1), without violating the prohibition against deferred compensation.

(i) ***Permitted benefits. —***The following features or benefits of insurance policies do not defer compensation —

(A) Credit toward the deductible for unreimbursed covered expenses incurred in prior periods;

(B) Reasonable lifetime maximum limit on benefits;

(C) Level premiums;

(D) Premium waiver during disability;

(E) Guaranteed policy renewability of coverage, without further evidence of insurability (but not guaranty of the amount of premium upon renewal);

(F) Coverage for a specified accidental injury;

(G) Coverage for a specified disease or illness, including payments at initial diagnosis of the specified disease or illness, and progressive payments of a set amount per month following the initial diagnosis (sometimes referred to as progressive diagnosis payments); and

(H) Payment of a fixed amount per day (or other period) of hospitalization.

(ii) ***Requirements of permitted benefits. —***All benefits described in paragraph (p)(1)(i) of this section must in addition satisfy all of the following requirements —

(A) No part of any benefit is used in one plan year to purchase a benefit in a subsequent plan year;

(B) The policies remain in force only so long as premiums are timely paid on a current basis, and, irrespective of the amount of premiums paid in prior plan years, if the current premiums are not paid, all coverage for new diseases or illnesses lapses. See paragraph (p)(1)(i)(D), allowing premium waiver during disability;

(C) There is no investment fund or cash value to rely upon for payment of premiums; and

(D) No part of any premium is held in a separate account for any participant or beneficiary, or otherwise segregated from the assets of the insurance company.

(2) ***Benefits under a long-term disability policy relating to more than one year. —***A long-term disability policy paying disability benefits over more than one year does not violate the prohibition against deferring compensation.

(3) ***Reasonable premium rebates or policy dividends. —***Reasonable premium rebates or policy dividends paid with respect to benefits provided through a cafeteria plan do not constitute impermissible deferred compensation if such rebates or dividends are paid before the close of the 12-month period immediately following the cafeteria plan year to which such rebates and dividends relate.

(4) ***Mandatory two-year election for vision or dental insurance. —***When a cafeteria plan offers vision or dental insurance that requires a mandatory two-year coverage period, but not longer (sometimes referred to as a "two-year lock-in"), the mandatory two-year coverage period does not result in deferred compensation in violation of section 125(d)(2), provided both of the following requirements are satisfied —

(i) The premiums for each plan year are paid no less frequently than annually; and

(ii) In no event does a cafeteria plan use salary reduction or flex-credits relating to the first year of a two-year election to apply to vision or dental insurance for the second year of the two-year election.

(5) ***Using salary reduction amounts from one plan year to pay accident and health insurance premiums for the first month of the immediately following plan year.***

(i) ***In general. —***Salary reduction amounts from the last month of one plan year of a cafeteria plan may be applied to pay accident and health insurance premiums for insurance during the first month of the immediately following plan year, if done on a uniform and consistent basis with respect to all participants (based on the usual payroll interval for each group of participants).

(ii) ***Example. —***The following example illustrates the rules in this paragraph (p)(5):

Example. Salary reduction payments in December of calendar plan year to pay accident and health insurance premiums for January. Employer S maintains a calendar year cafeteria plan. The cafeteria plan offers employees a salary reduction election for accident and health insurance. The plan provides that employees' salary reduction amounts for the last pay period in December are applied to pay accident and health insurance premiums for the immediately following January. All employees are paid bi-weekly. For the plan year ending December 31, 2009, Employee C elects salary reduction of $3,250 for accident and health coverage. For the last pay period in December 2009, $125 (3,250/26) is applied to the accident and health insurance premium for January 2010. This plan provision does not violate the prohibition against deferring compensation.

(q) ***Nonqualified benefits***

(1) ***In general*. —**The following benefits are nonqualified benefits that are not permitted to be offered in a cafeteria plan —

(i) Scholarships described in section 117;

(ii) Employer-provided meals and lodging described in section 119;

(iii) Educational assistance described in section 127;

(iv) Fringe benefits described in section 132;

(v) Long-term care insurance, or any product which is advertised, marketed or offered as long-term care insurance;

(vi) Long-term care services (but see paragraph (q)(3) of this section);

(vii) Group-term life insurance on the life of any individual other than an employee (whether includible or excludible from the employee's gross income);

(viii) Health reimbursement arrangements (HRAs) that provide reimbursements up to a maximum dollar amount for a coverage period and that all or any unused amount at the end of a coverage period is carried forward to increase the maximum reimbursement amount in subsequent coverage periods;

(ix) Contributions to Archer MSAs (section 220); and

(x) Elective deferrals to a section 403(b) plan.

(2) ***Nonqualified benefits not permitted in a cafeteria plan*. —**The benefits described in this paragraph (q) are not qualified benefits or taxable benefits or cash for purposes of section 125 and thus may not be offered in a cafeteria plan regardless of whether any such benefit is purchased with after-tax employee contributions or on any other basis. A plan that offers a nonqualified benefit is not a cafeteria plan. Employees' elections between taxable and nontaxable benefits through such plan result in gross income to the participants for any benefit elected. See section 125(f). See paragraph (q)(3) of this section for special rule on long-term care insurance purchased through an HSA.

(3) ***Long-term care insurance or services purchased through an HSA*. —**Although long-term care insurance is not a qualified benefit and may not be offered in a cafeteria plan, a cafeteria plan is permitted to offer an HSA as a qualified benefit, and funds from the HSA may be used to pay eligible long-term care premiums on a qualified long-term care insurance contract or for qualified long-term care services.

(r) ***Employer contributions to a cafeteria plan***

(1) ***Salary reduction-in general*. —**The term *employer contributions* means amounts that are not currently available (after taking section 125 into account) to the employee but are specified in the cafeteria plan as amounts that an employee may use for the purpose of electing benefits through the plan. A plan may provide that employer contributions may be made, in whole or in part, pursuant to employees' elections to reduce their compensation or to forgo increases in compensation and to have such amounts contributed, as employer contributions, by the employer on their behalf. See also §1.125-5 (flexible spending arrangements). Also, a cafeteria plan is permitted to require employees to elect to pay the employees' share of any qualified benefit through salary reduction and not with after-tax employee contributions. A cafeteria plan is also permitted to pay reasonable cafeteria plan administrative fees through salary reduction amounts, and these salary reduction amounts are excludible from an employee's gross income.

(2) ***Salary reduction as employer contribution*. —**Salary reduction contributions are employer contributions. An employee's salary reduction election is an election to receive a contribution by the employer in lieu of salary or other compensation that is not currently available to the employee as of the effective date of the election and that does not subsequently become currently available to the employee.

(3) ***Employer flex-credits*. —**A cafeteria plan may also provide that the employer contributions will or may be made on behalf of employees equal to (or up to) specified amounts (or specified percentages of compensation) and that such nonelective contributions are available to employees for the election of benefits through the plan.

(4) ***Elective contributions to a section 401(k) plan*. —**See §1.401(k)-1 for general rules relating to contributions to section 401(k) plans.

(s) ***Effective/applicability date*. —**It is proposed that these regulations apply on and after plan years beginning on or after January 1, 2009, except that the rule in paragraph (k)(2)(i)(B) of this section is effective as of the date the proposed regulations are published in the Federal Register. [Reg. §1.125-1.]

PROP-REG, 2007FED ¶7322, §1.125-2., **Cafeteria plans; elections, REG-142695-05, 8/6/2007.**

Cafeteria plans; elections, REG-142695-05, 8/6/2007.

(a) ***Rules relating to making and revoking elections***

(1) ***Elections in general*. —**A plan is not a cafeteria plan unless the plan provides in writing that employees are permitted to make elections among the permitted taxable benefits and qualified benefits offered through the plan for the plan year (and grace period, if applicable). All elections must be irrevocable by the date described in paragraph (a)(2) of this section except as provided in paragraph (a)(4) of this section. An election is not irrevocable if, after the earlier of the dates specified in paragraph (a)(2) of this section, employees have the right to revoke their elections of qualified benefits and instead receive the taxable benefits for such period, without regard to whether the employees actually revoke their elections.

(2) ***Timing of elections.*** **—**In order for employees to exclude qualified benefits from employees' gross income, benefit elections in a cafeteria plan must be made before the earlier of —

(i) The date when taxable benefits are currently available; or

(ii) The first day of the plan year (or other coverage period).

(3) ***Benefit currently available to an employee —in general.*** **—**Cash or another taxable benefit is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable benefit at the employee's discretion. However, cash or another taxable benefit is not currently available to an employee if there is a significant limitation or restriction on the employee's right to receive the benefit currently. Similarly, a benefit is not currently available as of a date if the employee may under no circumstances receive the benefit before a particular time in the future. The determination of whether a benefit is currently available to an employee does not depend on whether it has been constructively received by the employee for purposes of section 451.

(4) ***Exceptions to rule on making and revoking elections.*** **—**If a cafeteria plan incorporates the change in status rules in §1.125-4, to the extent provided in those rules, an employee who experiences a change in status (as defined in §1.125-4) is permitted to revoke an existing election and to make a new election with respect to the remaining portion of the period of coverage, but only with respect to cash or other taxable benefits that are not yet currently available. See paragraph (c)(1) of this section for a special rule for changing elections prospectively for HSA contributions and paragraph (r)(4) in §1.125-1 for section 401(k) elections. Also, only an employee of the employer sponsoring a cafeteria plan is allowed to make, revoke or change elections in the employer's cafeteria plan. The employee's spouse, dependent or any other individual other than the employee may not make, revoke or change elections under the plan.

(5) ***Elections not required on written paper documents.*** **—**A cafeteria plan does not fail to meet the requirements of section 125 merely because it permits employees to use electronic media for such transactions. The safe harbor in §1.401(a)-21 applies to electronic elections, revocations and changes in elections under section 125.

(6) ***Examples.*** **—**The following examples illustrate the rules in this paragraph (a):

Example 1. Election not revocable during plan year. Employer A's cafeteria plan offers each employee the opportunity to elect, for a plan year, between $5,000 cash for the plan year and a dependent care assistance program of up to $5,000 of dependent care expenses incurred by the employee during the plan year. The cafeteria plan requires employees to elect between these benefits before the beginning of the plan year. After the year has commenced, employees are prohibited from revoking their elections. The cafeteria plan allows revocation of elections based on changes in status (as described in §1.125-4). Employees who elected the dependent care assistance program do not include the $5,000 cash in gross income. The cafeteria plan satisfies the requirements in this paragraph (a).

Example 2. Election revocable during plan year. Same facts as *Example 1* except that Employer A's cafeteria plan allows employees to revoke their elections for dependent care assistance at any time during the plan year and receive the unused amount of dependent care assistance as cash. The cafeteria plan fails to satisfy the requirements in this paragraph (a), and is not a cafeteria plan. All employees are treated as having received the $5,000 in cash even if they do not revoke their elections. The same result occurs even though the cash is not payable until the end of the plan year.

(b) ***Automatic elections***

(1) ***In general.*** **—**For new employees or current employees who fail to timely elect between permitted taxable benefits and qualified benefits, a cafeteria plan is permitted, but is not required, to provide default elections for one or more qualified benefits (for example, an election made for any prior year is deemed to be continued for every succeeding plan year, unless changed).

(2) ***Example.*** **—**The following example illustrates the rules in this paragraph (b):

Example. Automatic elections for accident and health insurance.

(i) Employer B maintains a calendar year cafeteria plan. The cafeteria plan offers accident and health insurance with an option for employee-only or family coverage. All employees are eligible to participate in the cafeteria plan immediately upon hire.

(ii) The cafeteria plan provides for an automatic enrollment process: each new employee and each current employee is automatically enrolled in employee-only coverage under the accident and health insurance plan, and the employee's salary is reduced to pay the employee's share of the accident and health insurance premium, unless the employee affirmatively elects cash. Alternatively, if the employee has a spouse or child, the employee can elect family coverage.

(iii) When an employee is hired, the employee receives a notice explaining the automatic enrollment process and the employee's right to decline coverage and have no salary reduction. The notice includes the salary reduction amounts for employee-only coverage and family coverage, procedures for exercising the right to decline coverage, information on the time by which an election must be made, and the period for which an election is effective. The notice is also given to each current employee before the beginning of each subsequent plan year, except that the notice for a current employee includes a description of the employee's existing coverage, if any.

(iv) For a new employee, an election to receive cash or to have family coverage rather than employee-only coverage is effective if made when the employee is hired. For a current employee, an election is effective if made prior to the start of each calendar year or under any other circumstances permitted under §1.125-4. An election made for any prior year is deemed to be continued for every succeeding plan year, unless changed.

(v) Contributions used to purchase accident and health insurance through a cafeteria plan are not includible in the gross income of the employee solely because the plan provides for automatic enrollment as a default election whereby the employee's salary is reduced each year to pay for a portion of the accident and health insurance through the plan (unless the employee affirmatively elects cash).

(c) ***Election rules for salary reduction contributions to HSAs***

(1) ***Prospective elections and changes in salary reduction elections allowed..*** **—**Contributions may be made to an HSA through a cafeteria plan. A cafeteria plan offering HSA contributions through salary reduction may permit employees to make prospective salary reduction elections or change or revoke salary reduction elections for HSA contributions (for example, to increase or decrease salary reduction elections for HSA contributions) at any time during the plan year, effective before salary becomes currently available. If a cafeteria plan offers HSA contributions as a qualified benefit, the plan must —

(i) Specifically describe the HSA contribution benefit;

(ii) Allow a participant to prospectively change his or her salary reduction election for HSA contributions on a monthly basis (or more frequently); and

(iii) Allow a participant who becomes ineligible to make HSA contributions to prospectively revoke his or her salary reduction election for HSA contributions.

(2) ***Example.*** **—**The following example illustrates the rules in this paragraph (c):

Example. *Prospective HSA salary reduction elections*. (i) A cafeteria plan with a calendar plan year allows employees to make salary reduction elections for HSA contributions through the plan. The cafeteria plan permits employees to prospectively make, change or revoke salary contribution elections for HSA contributions, limited to one election, change or revocation per month.

(ii) Employee M participates in the cafeteria plan. Before salary becomes currently available to M, M makes the following elections. On January 2, 2009, M elects to contribute $100 for each pay period to an HSA, effective January 3, 2009. On March 15, 2009, M elects to reduce the HSA contribution to $35 per pay period, effective April 1, 2009. On May 1, 2009, M elects to discontinue all HSA contributions, effective May 15, 2009. The cafeteria plan implements all of Employee M's elections,

(iii) The cafeteria plan's operation is consistent with the section 125 election, change and revocation rules for HSA contributions.

(d) ***Optional election for new employees.*** **—**A cafeteria plan may provide new employees 30 days after their hire date to make elections between cash and qualified benefits. The election is effective as of the employee's hire date. However, salary reduction amounts used to pay for such an election must be from compensation not yet currently available on the date of the election. The written cafeteria plan must provide that any employee who terminates employment and is rehired within 30 days after terminating employment (or who returns to employment following an unpaid leave of absence of less than 30 days) is not a new employee eligible for the election in this paragraph (d).

(e) ***Effective/applicability date.*** **—**It is proposed that these regulations apply on and after plan years beginning on or after January 1, 2009. [Reg. §1.125-2.]

FINAL-REG, 2007FED ¶7323B, §1.125-3., **Effect of the Family and Medical Leave Act (FMLA) on the operation of cafeteria plans. —**

Effect of the Family and Medical Leave Act (FMLA) on the operation of cafeteria plans. —The following questions and answers provide guidance on the effect of the Family and Medical Leave Act (FMLA), 29 U.S.C. 2601 et seq., on the operation of cafeteria plans:

Q-1: May an employee revoke coverage or cease payment of his or her share of group health plan premiums when taking unpaid FMLA, 29 U.S.C. 2601 et seq., leave?

A-1: Yes. An employer must either allow an employee on unpaid FMLA leave to revoke coverage, or continue coverage but allow the employee to discontinue payment of his or her share of the premium for group health plan coverage (including a health flexible spending arrangement (FSA)) under a cafeteria plan for the period of the FMLA leave. See 29 CFR 825.209(e). FMLA does not require that an employer allow an employee to revoke coverage if the employer pays the employee's share of premiums. As discussed in Q&A-3, if the employer continues coverage during an FMLA leave, the employer may recover the employee's share of the premiums when the employee returns to work. FMLA also provides the employee a right to be reinstated in the group health plan coverage (including a health FSA) provided under a cafeteria plan upon returning from FMLA leave if the employee's group health plan coverage terminated while on FMLA leave (either by revocation or due to nonpayment of premiums). Such an employee is entitled, to the extent required under FMLA, to be reinstated on the same terms as prior to taking FMLA leave (including family or dependent coverage), subject to any changes in benefit levels that may have taken place during the period of FMLA leave as provided in 29 CFR 825.215(d)(1). See 29 CFR 825.209(e) and 825.215(d). In addition, such an employee has the right to revoke or change elections under §1.125-4 (e.g., because of changes in status or cost or coverage changes as provided under §1.125-4) under the same terms and conditions as are available to employees participating in the cafeteria plan who are working and not on FMLA leave.

Q-2: Who is responsible for making premium payments under a cafeteria plan when an employee on FMLA leave continues group health plan coverage?

A-2: FMLA provides that an employee is entitled to continue group health plan coverage during FMLA leave whether or not that coverage is provided under a health FSA or other component of a cafeteria plan. See 29 CFR 825.209(b). FMLA permits an employer to require an employee who chooses to continue group health plan coverage while on FMLA leave to be responsible for the share of group health premiums that would be allocable to the employee if the employee were working, and, for this purpose, treats amounts paid pursuant to a pre-tax salary reduction agreement as amounts allocable to the employee. However, FMLA requires the employer to continue to contribute the share of the cost of the employee's coverage that the employer was paying before the employee commenced FMLA leave. See 29 CFR 825.100(b) and 825.210(a).

Q-3: What payment options are required or permitted to be offered under a cafeteria plan to an employee who continues group health plan coverage while on unpaid FMLA leave, and what is the tax treatment of these payments?

A-3: (a) *In general*. Subject to the limitations described in paragraph (b) of this Q&A-3, a cafeteria plan may offer one or more of the following payment options, or a combination of these options, to an employee who continues group health plan coverage (including a health FSA) while on unpaid FMLA leave; provided that the payment options for employees on FMLA leave are offered on terms at least as favorable as those offered to employees not on FMLA leave. These options are referred to in this section as pre-pay, pay-as-you-go, and catch-up. See also the FMLA notice requirements at 29 CFR 825.301(b)(1)(iv).

(1) *Pre-pay*. (i) Under the pre-pay option, a cafeteria plan may permit an employee to pay, prior to commencement of the FMLA leave period, the amounts due for the FMLA leave period. However, FMLA provides that the employer may not mandate that an employee pre-pay the amounts due for the leave period. See 29 CFR 825.210(c)(3) and (4).

(ii) Contributions under the pre-pay option may be made on a pre-tax salary reduction basis from any taxable compensation (including from unused sick days or vacation days). However, see Q&A-5 of this section regarding additional restrictions on pre-tax salary reduction contributions when an employee's FMLA leave spans two cafeteria plan years.

(iii) Contributions under the pre-pay option may also be made on an after-tax basis.

(2) *Pay-as-you-go*. (i) Under the pay-as-you-go option, employees may pay their share of the premium payments on the same schedule as payments would have been made if the employee were not on leave or under any other payment schedule permitted by the Labor Regulations at 29 CFR 825.210(c) (e.g., on the same schedule as payments are made under section 4980B (relating to coverage under the Consolidated Omnibus Budget Reconciliation Act (COBRA), 26 U.S.C. 4980B), under the employer's existing rules for payment by employees on leave without pay, or under any other C6/ROP 10-12-01 system voluntarily agreed to between the employer and the employee that is not inconsistent with this section or with 29 CFR 825.210(c)).

(ii) Contributions under the pay-as-you-go option are generally made by the employee on an after-tax basis. However, contributions may be made on a pre-tax basis to the extent that the contributions are made from taxable compensation (e.g., from unused sick days or vacation days) that is due the employee during the leave period.

(iii) An employer is not required to continue the group health coverage of an employee who fails to make required premium payments while on FMLA leave, provided that the employer follows the notice procedures required under FMLA. See 29 CFR 825.212. However, if the employer chooses to continue the health coverage of an employee who fails to pay his or her share of the premium payments while on FMLA leave, FMLA permits the employer to recoup the premiums (to the extent of the employee's share). See 29 CFR 825.212(b). Such recoupment may be made as set forth in paragraphs (a)(3)(i) and (ii) of this Q&A-3. See also Q&A-6 of this section regarding coverage under a health FSA when an employee fails to make the required premium payments while on FMLA leave.

(3) *Catch-up*. (i) Under the catch-up option, the employer and the employee may agree in advance that the group coverage will continue during the period of unpaid FMLA leave, and that the employee will not pay premiums until the employee returns from the FMLA leave. Where an employee is electing to use the catch-up option, the employer and the employee must agree in advance of the coverage period that: the employee elects to continue health coverage while on unpaid FMLA leave; the employer assumes responsibility for advancing payment of the premiums on the employee's behalf during the FMLA leave; and these advance amounts are to be paid by the employee when the employee returns from FMLA leave.

(ii) When an employee fails to make required premium payments while on FMLA leave, an employer is permitted to utilize the catch-up option to recoup the employee's share of premium payments when the employee returns from FMLA leave. See, e.g., 29 CFR 825.212(b). If the employer chooses to continue group coverage under these circumstances, the prior agreement of the employee, as set forth in paragraph (a)(3)(i) of this Q&A-3, is not required.

(iii) Contributions under the catch-up option may be made on a pre-tax salary reduction basis from any available taxable compensation (including from unused sick days and vacation days) after the employee returns from FMLA leave. The cafeteria plan may provide for the catch-up option to apply on a pre-tax salary reduction basis if premiums have not been paid on any other basis (i.e., have not been paid under the pre-pay or pay-as-you-go options or on a catch-up after-tax basis).

(iv) Contributions under the catch-up option may also be made on an after-tax basis.

(b) *Exceptions*. Whatever payment options are offered to employees on non-FMLA leave must be offered to employees on FMLA leave. In accordance with 29 CFR 825.210(c), cafeteria plans may offer one or more of the payment options described in paragraph (a) of this Q&A-3, with the following exceptions:

(1) FMLA does not permit the pre-pay option to be the sole option offered to employees on FMLA leave. However, the cafeteria plan may include pre-payment as an option for employees on FMLA leave, even if such option is not offered to employees on non-FMLA leave-without-pay.

(2) FMLA allows the catch-up option to be the sole option offered to employees on FMLA leave if and only if the catch-up option is the sole option offered to employees on non-FMLA leave-without-pay.

(3) If the pay-as-you-go option is offered to employees on non-FMLA leave-without-pay, the option must also be offered to employees on FMLA leave. The employer may also offer employees on FMLA leave the pre-pay option and/or the catch-up option.

(c) *Voluntary waiver of employee payments*. In addition to the foregoing payment options, an employer may voluntarily waive, on a nondiscriminatory basis, the requirement that employees who elect to continue group health coverage while on FMLA leave pay the amounts the employees would otherwise be required to pay for the leave period.

(d) *Example*. The following example illustrates this Q&A-3:

Example. (i) Employer Y allows employees to pay premiums for group health coverage during an FMLA leave on an after-tax basis while the employee is on unpaid FMLA leave. Under the terms of Y's cafeteria plan, if an employee elects to continue health coverage during an unpaid FMLA leave and fails to pay one or more of the after-tax premium payments due for that coverage, the employee's salary after the employee returns from FMLA leave is reduced to cover unpaid premiums (i.e. the premiums that were to be paid by the employee on an after-tax basis during the FMLA leave, but were paid by the employer instead).

(ii) In this *Example*, Y's cafeteria plan satisfies the conditions in this Q&A-3. Y's cafeteria plan would also satisfy the conditions in this Q&A-3 if the plan provided for coverage to cease in the event the employee fails to make a premium payment when due during an unpaid FMLA leave.

Q-4: Do the special FMLA requirements concerning payment of premiums by an employee who continues group health plan coverage under a cafeteria plan apply if the employee is on paid FMLA leave?

A-4: No. The Labor Regulations provide that, if an employee's FMLA leave is paid leave as described at 29 CFR 825.207 and the employer mandates that the employee continue group health plan coverage while on FMLA leave, the employee's share of the premiums must be paid by the method normally used during any paid leave (e.g., by pre-tax salary reduction if the employee's share of premiums were paid by pre-tax salary reduction before the FMLA leave began). See 29 CFR 825.210(b).

Q-5: What restrictions apply to contributions when an employee's FMLA leave spans two cafeteria plan years?

A-5: (a) No amount will be included in an employee's gross income due to participation in a cafeteria plan during FMLA leave, provided that the plan complies with other generally applicable cafeteria plan requirements. Among other requirements, a plan may not operate in a manner that enables employees on FMLA leave to defer compensation from one cafeteria plan year to a subsequent cafeteria plan year. See section 125(d)(2).

(b) The following example illustrates this Q&A-5:

Example. (i) Employee A elects group health coverage under a calendar year cafeteria plan maintained by Employer X. Employee A's premium for health coverage is $100 per month throughout the 12-month period of coverage. Employee A takes FMLA leave for 12 weeks beginning on October 31 after making 10 months of premium payments totaling $1,000 (10 months × $100 = $1,000). Employee A elects to continue health coverage while on FMLA leave and utilizes the pre-pay option by applying his or her unused sick days in order to make the required premium payments due while he or she is on FMLA leave.

(ii) Because A cannot defer compensation from one plan year to a subsequent plan year, A may pre-pay the premiums due in November and December (i.e., $100 per month) on a pre-tax basis, but A cannot pre-pay the premium payment due in January on a pre-tax basis. If A participates in the cafeteria plan in the subsequent plan year, A must either pre-pay for January on an after-tax basis or use another option (e.g., pay- as-you-go, catch-up, reduction in unused sick days, etc.) to make the premium payment due in January.

Q-6: Are there special rules concerning employees taking FMLA leave who participate in health FSAs offered under a cafeteria plan?

A-6: (a) *In general*. (1) A group health plan that is a flexible spending arrangement (FSA) offered under a cafeteria plan must conform to the generally applicable rules in this section concerning employees who take FMLA leave. Thus, to the extent required by FMLA (see 29 CFR 825.209(b)), an employer must —

(i) Permit an employee taking FMLA leave to continue coverage under a health FSA while on FMLA leave; and

(ii) If an employee is on unpaid FMLA leave, either —

(A) Allow the employee to revoke coverage; or

(B) Continue coverage, but allow the employee to discontinue payment of his or her share of the premium for the health FSA under the cafeteria plan during the unpaid FMLA leave period.

(2) Under FMLA, the plan must permit the employee to be reinstated in health coverage upon return from FMLA leave on the same terms as if the employee had been working throughout the leave period, without a break in coverage. See 29 CFR 825.214(a) and 825.215(d)(1) and paragraph (b)(2) of this Q&A-6. In addition, under FMLA, a plan may require an employee to be reinstated in health coverage upon return from a period of unpaid FMLA leave, provided that employees who return from a period of unpaid leave not covered by the FMLA are also required to resume participation upon return from leave.

(b) *Coverage*. (1) Regardless of the payment option selected under Q&A-3 of this section, for so long as the employee continues health FSA coverage (or for so long as the employer continues the health FSA coverage of an employee who fails to make the required contributions as described in Q&A-3(a)(2)(iii) of this section), the full amount of the elected health FSA coverage, less any prior reimbursements, must be available to the employee at all times, including the FMLA leave period.

(2) (i) If an employee's coverage under the health FSA terminates while the employee is on FMLA leave, the employee is not entitled to receive reimbursements for claims incurred during the period when the coverage is terminated. If an employee subsequently elects or the employer requires the employee to be reinstated in the health FSA upon return from FMLA leave for the remainder of the plan year, the employee may not retroactively elect health FSA coverage for claims incurred during the period when the coverage was terminated. Upon reinstatement into a health FSA upon return from FMLA leave (either because the employee elects reinstatement or because the employer requires reinstatement), the employee has the right under FMLA: to resume coverage at the level in effect before the FMLA leave and make up the unpaid premium payments, or to resume coverage at a level that is reduced and resume premium payments at the level in effect before the FMLA leave. If an employee chooses to resume health FSA coverage at a level that is reduced, the coverage is prorated for the period during the FMLA leave for which no premiums were paid. In both cases, the coverage level is reduced by prior reimbursements.

(ii) FMLA requires that an employee on FMLA leave have the right to revoke or change elections (because of events described in §1.125-4) under the same terms and conditions that apply to employees participating in the cafeteria plan who are not on FMLA leave. Thus, for example, if a group health plan offers an annual open enrollment period to active employees, then, under FMLA, an employee on FMLA leave when the open enrollment is offered must be offered the right to make election changes on the same basis as other employees. Similarly, if a group health plan decides to offer a new benefit package option and allows active employees to elect the new option, then, under FMLA, an employee on FMLA leave must be allowed to elect the new option on the same basis as other employees.

(3) The following examples illustrate the rules in this Q&A-6:

Example 1. (i) Employee B elects $1,200 worth of coverage under a calendar year health FSA provided under a cafeteria plan, with an annual premium of $1,200. Employee B is permitted to pay the $1,200 through pre-tax salary reduction amounts of $100 per month throughout the 12-month period of coverage. Employee B incurs no medical expenses prior to April 1. On April 1, B takes FMLA leave after making three months of contributions totaling $300 (3 months × $100 = $300). Employee B's coverage ceases during the FMLA leave. Consequently, B makes no premium payments for the months of April, May, and June, and B is not entitled to submit claims or receive reimbursements for expenses incurred during this period. Employee B returns from FMLA leave and elects to be reinstated in the health FSA on July 1.

(ii) Employee B must be given a choice of resuming coverage at the level in effect before the FMLA leave (i.e., $1,200) and making up the unpaid premium payments ($300), or resuming health FSA coverage at a level that is reduced on a prorata basis for the period during the FMLA leave for which no premiums were paid (i.e., reduced for 3 months or 1/4 of the plan year) less prior reimbursements (i.e., $0) with premium payments due in the same monthly amount payable before the leave (i.e., $100 per month). Consequently, if B chooses to resume coverage at the level in effect before the FMLA leave, B's coverage for the remainder of the plan year would equal $1,200 and B's monthly premiums would be increased to $150 per month for the remainder of the plan year, to make up the $300 in premiums missed ($100 per month plus $50 per month ($300 divided by the remaining 6 months)). If B chooses prorated coverage, B's coverage for the remainder of the plan year would equal $900, and B would resume making premium payments of $100 per month for the remainder of the plan year.

Example 2. (i) Assume the same facts as *Example 1* except that B incurred medical expenses totaling $200 in February and obtained reimbursement of these expenses.

(ii) The results are the same as in *Example 1*, except that if B chooses to resume coverage at the level in effect before the FMLA leave, B's coverage for the remainder of the year would equal $1,000 ($1,200 reduced by $200) and the monthly payments for the remainder of the year would still equal $150. If instead B chooses prorated coverage, B's coverage for the remainder of the plan year would equal $700 ($1,200 prorated for 3 months, and then reduced by $200) and the monthly payments for the remainder of the year would still equal $100.

Example 3. (i) Assume the same facts as *Example 1* except that, prior to taking FMLA leave, B elects to continue health FSA coverage during the FMLA leave. The plan permits B (and B elects) to use the catch-up payment option described in Q&A-3 of this section, and as further permitted under the plan, B chooses to repay the $300 in missed payments on a ratable basis over the remaining 6-month period of coverage (i.e., $50 per month).

(ii) Thus, B's monthly premium payments for the remainder of the plan year will be $150 ($100 + $50).

Q-7: Are employees entitled to non-health benefits while taking FMLA leave?

A-7: FMLA does not require an employer to maintain an employee's non-health benefits (e.g., life insurance) during FMLA leave. An employee's entitlement to benefits other than group health benefits under a cafeteria plan during a period of FMLA leave is to be determined by the employer's established policy for providing such benefits when the employee is on non-FMLA leave (paid or unpaid). See 29 CFR 825.209(h). Therefore, an employee who takes FMLA leave is entitled to revoke an election of non-health benefits under a cafeteria plan to the same extent as employees taking non-FMLA leave are permitted to revoke elections of non-health benefits under a cafeteria plan. For example, election changes are permitted due to changes of status or upon enrollment for a new plan year. See §1.125-4. However, FMLA provides that, in certain cases, an employer may continue an employee's non-health benefits under the employer's cafeteria plan while the employee is on FMLA leave in order to ensure that the employer can meet its responsibility to provide equivalent benefits to the employee upon return from unpaid FMLA. If the employer continues an employee's non-health benefits during FMLA leave, the employer is entitled to recoup the costs incurred for paying the employee's share of the premiums during the FMLA leave period. See 29 CFR 825.213(b). Such recoupment may be on a pre-tax basis. A cafeteria plan must, as required by FMLA, permit an employee whose coverage terminated while on FMLA leave (either by revocation or nonpayment of premiums) to be reinstated in the cafeteria plan on return from FMLA leave. See 29 CFR 825.214(a) and 825.215(d).

Q-8: What is the applicability date of the regulations in this section?

A-8: This section is applicable for cafeteria plan years beginning on or after January 1, 2002. [Reg. §1.125-3.]

.01 Historical Comment: Proposed 12/21/95. Adopted 10/16/2001 by T.D. 8966 (corrected 12/10/2001).

FINAL-REG, 2007FED ¶7323C, §1.125-4., **Permitted election changes**

Permitted election changes

(a) ***Election changes*****. —**A cafeteria plan may permit an employee to revoke an election during a period of coverage and to make a new election only as provided in paragraphs (b) through (g) of this section. Section 125 does not require a cafeteria plan to permit any of these changes. See paragraph (h) of this section for special provisions relating to qualified cash or deferred arrangements, and paragraph (i) of this section for special definitions used in this section.

(b) ***Special enrollment rights***

(1) ***In general*****. —**A cafeteria plan may permit an employee to revoke an election for coverage under a group health plan during a period of coverage and make a new election that corresponds with the special enrollment rights provided in section 9801(f).

(2) ***Examples*****. —**The following examples illustrate the application of this paragraph (b):

Example 1. (i) Employer *M* provides health coverage for its employees pursuant to a plan that is subject to section 9801(f). Under the plan, employees may elect either employee-only coverage or family coverage. *M* also maintains a calendar year cafeteria plan under which qualified benefits, including health coverage, are funded through salary reduction. *M*'s employee, *A*, is married to *B* and they have a child, *C*. In accordance with *M*'s cafeteria plan, Employee *A* elects employee-only health coverage before the beginning of the calendar year. During the year, *A* and *B* adopt a child, *D*. Within 30 days thereafter, *A* wants to revoke *A*'s election for employee-only health coverage and obtain family health coverage for *A*'s spouse, *C*, and *D* as of the date of *D*'s adoption. Employee *A* satisfies the conditions for special enrollment of an employee with a new dependent under section 9801(f)(2), so that *A* may enroll in family coverage under *M*'s accident or health plan in order to provide coverage effective as of the date of *D*'s adoption.

(ii) *M*'s cafeteria plan may permit *A* to change A's salary reduction election to family coverage for salary not yet currently available. The increased salary reduction is permitted to reflect the cost of family coverage from the date of adoption. (*A*'s adoption of *D* is also a change in status, and the election of family coverage is consistent with that change in status. Thus, under paragraph (c) of this section, *M*'s cafeteria plan could permit *A* to elect family coverage prospectively in order to cover *B*, *C*, and *D* for the remaining portion of the period of coverage.)

Example 2. (i) The employer plans and permissible coverage are the same as in *Example 1*. Before the beginning of the calendar year, Employee *E* elects employee-only health coverage under *M*'s cafeteria plan. Employee *E* marries *F* during the plan year. *F*'s employer, *N*, offers health coverage to *N*'s employees, and, prior to the marriage, *F* had elected employee-only coverage. Employee *E* wants to revoke the election for employee-only coverage under *M*'s cafeteria plan, and is considering electing family health coverage under *M*'s plan or obtaining family health coverage under *N*'s plan.

(ii) *M*'s cafeteria plan may permit *E* to change *E*'s salary reduction election to reflect the change to family coverage under *M*'s accident or health plan because the marriage would result in special enrollment rights under section 9801(f), pursuant to which an election of family coverage under *M*'s accident or health plan would be required to be effective no later than the first day of the first calendar month beginning after the completed request for enrollment is received by the plan. Since no retroactive coverage is required in the event of marriage under section 9801(f), *E*'s salary reduction election may only be changed on a prospective basis. (*E*'s marriage to *F* is also a change in status under paragraph (c) of this section, as illustrated in *Example 1* of paragraph (c)(4) of this section.)

(c) ***Changes in status***

(1) ***Change in status rule*. —**A cafeteria plan may permit an employee to revoke an election during a period of coverage with respect to a qualified benefits plan (defined in paragraph (i)(8) of this section) to which this paragraph (c) applies and make a new election for the remaining portion of the period (referred to in this section as an election change) if, under the facts and circumstances —

(i) change in status described in paragraph (c)(2) of this section occurs; and

(ii) The election change satisfies the consistency rule of paragraph (c)(3) of this section.

(2) ***Change in status events*. —**The following events are changes in status for purposes of this paragraph (c):

(i) ***Legal marital status*. —**Events that change an employee's legal marital status, including the following: marriage; death of spouse; divorce; legal separation; and annulment.

(ii) ***Number of dependents*. —**Events that change an employee's number of dependents, including the following: birth; death; adoption; and placement for adoption.

(iii) ***Employment status*. —**Any of the following events that change the employment status of the employee, the employee's spouse, or the employee's dependent: a termination or commencement of employment; a strike or lockout; a commencement of or return from an unpaid leave of absence; and a change in worksite. In addition, if the eligibility conditions of the cafeteria plan or other employee benefit plan of the employer of the employee, spouse, or dependent depend on the employment status of that individual and there is a change in that individual's employment status with the consequence that the individual becomes (or ceases to be) eligible under the plan, then that change constitutes a change in employment under this paragraph (c) (e.g., if a plan only applies to salaried employees and an employee switches from salaried to hourly-paid with the consequence that the employee ceases to be eligible for the plan, then that change constitutes a change in employment status under this paragraph (c)(2)(iii)).

(iv) ***Dependent satisfies or ceases to satisfy eligibility requirements*. —**Events that cause an employee's dependent to satisfy or cease to satisfy eligibility requirements for coverage on account of attainment of age, student status, or any similar circumstance.

(v) ***Residence*. —**A change in the place of residence of the employee, spouse, or dependent.

(vi) ***Adoption assistance*. —**For purposes of adoption assistance provided through a cafeteria plan, the commencement or termination of an adoption proceeding.

(3) ***Consistency rule***

(i) ***Application to accident or health coverage and group-term life insurance*. —**An election change satisfies the requirements of this paragraph (c)(3) with respect to accident or health coverage or group-term life insurance only if the election change is on account of and corresponds with a change in status that affects eligibility for coverage under an employer's plan. A change in status that affects eligibility under an employer's plan includes a change in status that results in an increase or decrease in the number of an employee's family members or dependents who may benefit from coverage under the plan.

(ii) ***Application to other qualified benefits*. —**[Reserved]

(iii) ***Application of consistency rule*****. —**If the change in status is the employee's divorce, annulment or legal separation from a spouse, the death of a spouse or dependent, or a dependent ceasing to satisfy the eligibility requirements for coverage, an employee's election under the cafeteria plan to cancel accident or health insurance coverage for any individual other than the spouse involved in the divorce, annulment or legal separation, the deceased spouse or dependent, or the dependent that ceased to satisfy the eligibility requirements for coverage, respectively, fails to correspond with that change in status. Thus, if a dependent dies or ceases to satisfy the eligibility requirements for coverage, the employee's election to cancel accident or health coverage for any other dependent, for the employee, or for the employee's spouse fails to correspond with that change in status. In addition, if an employee, spouse, or dependent gains eligibility for coverage under a family member plan (as defined in paragraph (i)(5) of this section) as a result of a change in marital status under paragraph (c)(2)(i) of this section or a change in employment status under paragraph (c)(2)(iii) of this section, an employee's election under the cafeteria plan to cease or decrease coverage for that individual under the cafeteria plan corresponds with that change in status only if coverage for that individual becomes applicable or is increased under the family member plan. With respect to group-term life insurance and disability coverage (as defined in paragraph (i)(4) of this section), an election under a cafeteria plan to increase coverage (or an election to decrease coverage) in response to a change in status described in paragraph (c)(2) of this section is deemed to correspond with that change in status as required by paragraph (c)(3)(i) of this section.

(iv) ***Exception for COBRA*****. —**If the employee, spouse, or dependent becomes eligible for continuation coverage under the group health plan of the employee's employer as provided in section 4980B or any similar state law, a cafeteria plan may permit the employee to elect to increase payments under the employer's cafeteria plan in order to pay for the continuation coverage.

(4) ***Examples*****. —**The following examples illustrate the application of this paragraph (c):

Example 1. (i) Employer *M* provides health coverage (including a health FSA) for its employees through its cafeteria plan. Before the beginning of the calendar year, Employee *A* elects employee-only health coverage under *M*'s cafeteria plan and elects salary reduction contributions to fund coverage under the health FSA. Employee *A* marries *B* during the year. Employee *B'*s employer, *N*, offers health coverage to *N*'s employees (but not including any health FSA), and, prior to the marriage, *B* had elected employee-only coverage. Employee *A* wants to revoke the election for employee- only coverage, and is considering electing family health coverage under *M*'s plan or obtaining family health coverage under *N*'s plan.

(ii) Employee *A*'s marriage to *B* is a change in status under paragraph (c)(2)(i) of this section, pursuant to which *B* has become eligible for coverage under *M*'s health plan under paragraph (c)(3)(i) of this section. Two possible election changes by *A* correspond with the change in status: Employee *A* may elect family health coverage under *M*'s plan to cover *A* and *B*; or *A* may cancel coverage under *M*'s plan, if *B* elects family health coverage under *N*'s plan to cover *A* and *B*. Thus, *M*'s cafeteria plan may permit *A* to make either election change.

(iii) Employee *A* may also increase salary reduction contributions to fund coverage for *B* under the health FSA.

Example 2. (i) Employee *C*, a single parent, elects family health coverage under a calendar year cafeteria plan maintained by Employer *O*. Employee *C* and *C*'s 21-year old child, *D*, are covered under *O*'s health plan. During the year, *D* graduates from college. Under the terms of the health plan, dependents over the age of 19 must be full-time students to receive coverage. Employee *C* wants to revoke *C*'s election for family health coverage and obtain employee-only coverage under *O*'s cafeteria plan.

(ii) *D*'s loss of eligibility for coverage under the terms of the health plan is a change in status under paragraph (c)(2)(iv) of this section. A revocation of *C*'s election for family coverage and new election for employee-only coverage corresponds with the change in status. Thus, *O*'s cafeteria plan may permit *C* to elect employee-only coverage.

Example 3. (i) Employee *E* is married to *F* and they have one child, *G*. Employee *E* is employed by Employer *P*, and *P* maintains a calendar year cafeteria plan that allows employees to elect no health coverage, employee-only coverage, employee-plus-one-dependent coverage, or family coverage. Under the plan, before the beginning of the calendar year, *E* elects family health coverage for *E*, *F*, and *G*. *E* and *F* divorce during the year and *F* loses eligibility for coverage under *P*'s plan. *G* does not lose eligibility for health coverage under *P*'s plan upon the divorce. *E* now wants to revoke *E*'s election under the cafeteria plan and elect no coverage.

(ii) The divorce is a change in status under paragraph (c)(2)(i). A change in the cafeteria plan election to cancel health coverage for *F* is consistent with that change in status. However, an election change to cancel *E*'s or *G'*s health coverage does not satisfy the consistency rule under paragraph (c)(3)(iii) of this section regarding cancellation of coverage for an employee's other dependents in the event of divorce. Therefore, the cafeteria plan may not permit *E* to elect no coverage. However, an election to change to employee-plus-one-dependent health coverage would correspond with the change in status, and thus the cafeteria plan may permit *E* to elect employee- plus-one-dependent health coverage.

(iii) In addition, under paragraph (f)(4) of this section, if *F* makes an election change to cover *G* under *F*'s employer's plan, then *E* may make a corresponding change to elect employee-only coverage under *P*'s cafeteria plan.

Example 4. (i) Employer *R* maintains a calendar year cafeteria plan under which full-time employees may elect coverage under one of three benefit package options provided under an accident or health plan: an indemnity option or either of two HMO options for employees who work in the respective service areas of the two HMOs. Employee *A*, who works in the service area of HMO #1, elects the HMO #1 option. During the year, *A* is transferred to another work location which is outside the HMO #1 service area and inside the HMO #2 service area.

(ii) The transfer is a change in status under paragraph (c)(2)(iii) of this section (relating to a change in worksite), and, under the consistency rule in paragraph (c)(3) of this section, the cafeteria plan may permit *A* to make an election change to elect the indemnity option or HMO #2 or to cancel accident or health coverage.

(iii) The change in work location has no effect on *A*'s eligibility under R's health FSA, so no change in *A*'s health FSA is authorized under this paragraph (c).

Example 5. (i) Employer *S* maintains a calendar year cafeteria plan that allows employees to elect coverage under an accident or health plan providing indemnity coverage and coverage under a health FSA. Prior to the beginning of the calendar year, Employee *B* elects employee-only indemnity coverage, and elects salary reduction contributions of $600 during the year to fund coverage under the health FSA for up to $600 of reimbursements for the year. Employee *B*'s spouse, *C*, has employee-only coverage under an accident or health plan maintained by *C*'s employer. During the year, *C* terminates employment and loses coverage under that plan. *B* now wants to elect family coverage under *S*'s accident or health plan and increase *B*'s FSA election.

(ii) *C*'s termination of employment is a change in status under paragraph (c)(2)(iii) of this section, and the election change satisfies the consistency rule of paragraph (c)(3) of this section. Therefore, the cafeteria plan may permit *B* to elect family coverage under *S*'s accident or health plan and to increase *B*'s FSA coverage.

Example 6. (i) Employer *T* provides group-term life insurance coverage as described under section 79. Under *T*'s plan, an employee may elect life insurance coverage in an amount up to $50,000. *T* also maintains a calendar year cafeteria plan under which qualified benefits, including the group-term life insurance coverage, are funded through salary reduction. Employee *D* has a spouse and a child. Before the beginning of the year, *D* elects $10,000 of group-term life insurance coverage. During the year, *D* is divorced.

(ii) The divorce is a change in status under paragraph (c)(2)(i) of this section. Under paragraph (c)(3)(iii) of this section, either an increase or a decrease in coverage is consistent with this change in status. Thus, *T*'s cafeteria plan may permit *D* to increase or to decrease *D*'s group-term life insurance coverage.

Example 7. (i) Employee *E* is married to *F* and they have one child, *G*. Employee *E*'s employer, *U*, maintains a cafeteria plan under which employees may elect no coverage, employee-only coverage, or family coverage under a group health plan maintained by *U*, and may make a separate vision coverage election under the plan. Before the beginning of the calendar year, *E* elects family health coverage and no vision coverage under *U*'s cafeteria plan. Employee *F*'s employer, *V*, maintains a cafeteria plan under which employees may elect no coverage, employee-only coverage, or family coverage under a group health plan maintained by *V*, and may make a separate vision coverage election under the plan. Before the beginning of the calendar year, *F* elects no health coverage and employee-only vision coverage under *V*'s plan. During the year, *F* terminates employment with *V* and loses vision coverage under *V*'s plan. Employee *E* now wants to elect family vision coverage under *U*'s group health plan.

(ii) *F*'s termination of employment is a change in status under paragraph (c)(2)(iii) of this section, and the election change satisfies the consistency rule of paragraph (c)(3) of this section. Therefore, *U*'s cafeteria plan may permit *E* to elect family vision coverage (covering *E* and *G* as well as *F*) under *U*'s group health plan.

Example 8. (i) Before the beginning of the year, Employee *H* elects to participate in a cafeteria plan maintained by *H*'s employer, *W*. However, in order to change the election during the year so as to cancel coverage, and by prior understanding with *W*, *H* terminates employment and resumes employment one week later.

(ii) In this *Example 8*, under the facts and circumstances, a principal purpose of the termination of employment was to alter the election, and reinstatement of employment was understood at the time of termination. Accordingly, *H* does not have a change in status under paragraph (c)(2)(iii) of this section.

(iii) However, *H*'s termination of employment would constitute a change in status, permitting a cancellation of coverage during the period of unemployment, if *H*'s original cafeteria plan election for the period of coverage was reinstated upon resumption of employment (for example, if *W*'s cafeteria plan contains a provision requiring an employee who resumes employment within 30 days, without any other intervening event that would permit a change in election, to return to the election in effect prior to termination of employment).

(iv) If, instead, *H* terminates employment and cancels coverage during a period of unemployment, and then returns to work more than 30 days following termination of employment, the cafeteria plan may permit *H* the option of returning to the election in effect prior to termination of employment or making a new election under the plan. Alternatively, the cafeteria plan may prohibit *H* from returning to the plan during that plan year.

Example 9. (i) Employee *A* has one child, *B*. Employee *A*'s employer, *X*, maintains a calendar year cafeteria plan that allows employees to elect coverage under a dependent care FSA. Prior to the beginning of the calendar year, *A* elects salary reduction contributions of $4,000 during the year to fund coverage under the dependent care FSA for up to $4,000 of reimbursements for the year. During the year, *B* reaches the age of 13, and *A* wants to cancel coverage under the dependent care FSA.

(ii) When *B* turns 13, *B* ceases to satisfy the definition of qualifying individual under section 21(b)(1) of the Internal Revenue Code. Accordingly, *B*'s attainment of age 13 is a change in status under paragraph (c)(2)(iv) of this section that affects *A*'s employment-related expenses as defined in section 21(b)(2). Therefore, *A* may make a corresponding change under *X*'s cafeteria plan to cancel coverage under the dependent care FSA.

Example 10. (i) Employer *Y* maintains a calendar year cafeteria plan under which full-time employees may elect coverage under either an indemnity option or an HMO. Employee *C* elects the employee-only indemnity option. During the year, *C* marries *D*. *D* has two children from a previous marriage, and has family group health coverage in a cafeteria plan sponsored by *D*'s employer, *Z*. *C* wishes to change from employee-only indemnity coverage to HMO coverage for the family. *D* wishes to cease coverage in *Z*'s group health plan and certifies to *Z* that *D* will have family coverage under *C*'s plan (and *Z* has no reason to believe the certification is incorrect).

(ii) The marriage is a change in status under paragraph (c)(2)(i) of this section. Under the consistency rule in paragraph (c)(3) of this section, *Y*'s cafeteria plan may permit *C* to change his or her salary reduction contributions to reflect the change from employee-only indemnity to HMO family coverage, and *Z* may permit *D* to revoke coverage under *Z*'s cafeteria plan.

(d) ***Judgment, decree, or order***

(1) ***Conforming election change.*** **—**This paragraph (d) applies to a judgment, decree, or order (order) resulting from a divorce, legal separation, annulment, or change in legal custody (including a qualified medical child support order as defined in section 609 of the Employee Retirement Income Security Act of 1974 (Public Law 93-406 (88 Stat. 829))) that requires accident or health coverage for an employee's child or for a foster child who is a dependent of the employee . A cafeteria plan will not fail to satisfy section 125 if it —

(i) Changes the employee's election to provide coverage for the child if the order requires coverage for the child under the employee's plan; or

(ii) Permits the employee to make an election change to cancel coverage for the child if:

(A) The order requires the spouse, former spouse, or other individual to provide coverage for the child; and

(B) That coverage is, in fact, provided.

(2) ***Example.*** **—**The following example illustrates the application of this paragraph (d):

Example. (i) Employer *M* maintains a calendar year cafeteria plan that allows employees to elect no health coverage, employee-only coverage, employee-plus-one-dependent coverage, or family coverage. *M*'s employee, *A*, is married to *B* and they have one child, *C*. Before the beginning of the year, *A* elects employee-only health coverage. Employee *A* divorces *B* during the year and, pursuant to *A*'s divorce agreement with B, *M*'s health plan receives a qualified medical child support order (as defined in section 609 of the Employee Retirement Income Security Act of 1974) during the plan year. The order requires *M*'s health plan to cover *C*.

(ii) Under this paragraph (d), *M*'s cafeteria plan may change *A*'s election from employee-only health coverage to employee-plus-one-dependent coverage in order to cover *C*.

(e) ***Entitlement to Medicare or Medicaid.*** **—**If an employee, spouse, or dependent who is enrolled in an accident or health plan of the employer becomes entitled to coverage (i.e., becomes enrolled) under Part A or Part B of Title XVIII of the Social Security Act (Medicare) (Public Law 89-97 (79 Stat. 291)) or Title XIX of the Social Security Act (Medicaid) (Public Law 89-97 (79 Stat. 343)), other than coverage consisting solely of benefits under section 1928 of the Social Security Act (the program for distribution of pediatric vaccines), a cafeteria plan may permit the employee to make a prospective election change to cancel or reduce coverage of that employee, spouse, or dependent under the accident or health plan. In addition, if an employee, spouse, or dependent who has been entitled to such coverage under Medicare or Medicaid loses eligibility for such coverage, the cafeteria plan may permit the employee to make a prospective election to commence or increase coverage of that employee, spouse, or dependent under the accident or health plan.

(f) ***Significant cost or coverage changes***

(1) ***In general.*** **—**Paragraphs (f)(2) through (5) of this section set forth rules for election changes as a result of changes in cost or coverage. This paragraph (f) does not apply to an election change with respect to a health FSA (or on account of a change in cost or coverage under a health FSA).

(2) ***Cost changes***

(i) ***Automatic changes.*** **—**If the cost of a qualified benefits plan increases (or decreases) during a period of coverage and, under the terms of the plan, employees are required to make a corresponding change in their payments, the cafeteria plan may, on a reasonable and consistent basis, automatically make a prospective increase (or decrease) in affected employees' elective contributions for the plan.

(ii) ***Significant cost changes.*** **—**If the cost charged to an employee for a benefit package option (as defined in paragraph (i)(2) of this section) significantly increases or significantly decreases during a period of coverage, the cafeteria plan may permit the employee to make a corresponding change in election under the cafeteria plan. Changes that may be made include commencing participation in the cafeteria plan for the option with a decrease in cost, or, in the case of an increase in cost, revoking an election for that coverage and, in lieu thereof, either receiving on a prospective basis coverage under another benefit package option providing similar coverage or dropping coverage if no other benefit package option providing similar coverage is available. For example, if the cost of an indemnity option under an accident or health plan significantly increases during a period of coverage, employees who are covered by the indemnity option may make a corresponding prospective increase in their payments or may instead elect to revoke their election for the indemnity option and, in lieu thereof, elect coverage under another benefit package option including an HMO option (or drop coverage under the accident or health plan if no other benefit package option is offered).

(iii) ***Application of cost changes.*** **—**For purposes of paragraphs (f)(2)(i) and (ii) of this section, a cost increase or decrease refers to an increase or decrease in the amount of the elective contributions under the cafeteria plan, whether that increase or decrease results from an action taken by the employee (such as switching between full-time and part-time status) or from an action taken by an employer (such as reducing the amount of employer contributions for a class of employees).

(iv) ***Application to dependent care.*** **—**This paragraph (f)(2) applies in the case of a dependent care assistance plan only if the cost change is imposed by a dependent care provider who is not a relative of the employee. For this purpose, a relative is an individual who is related as described in sections 152(a)(1) through (8), incorporating the rules of sections 152(b)(1) and (2).

(3) ***Coverage changes***

(i) ***Significant curtailment without loss of coverage.*** **—**If an employee (or an employee's spouse or dependent) has a significant curtailment of coverage under a plan during a period of coverage that is not a loss of coverage as described in paragraph (f)(3)(ii) of this section (for example, there is a significant increase in the deductible, the copay, or the out-of-pocket cost sharing limit under an accident or health plan), the cafeteria plan may permit any employee who had been participating in the plan and receiving that coverage to revoke his or her election for that coverage and, in lieu thereof, to elect to receive on a prospective basis coverage under another benefit package option providing similar coverage. Coverage under a plan is significantly curtailed only if there is an overall reduction in coverage provided under the plan so as to constitute reduced coverage generally. Thus, in most cases, the loss of one particular physician in a network does not constitute a significant curtailment.

(ii) ***Significant curtailment with loss of coverage.*** **—**If an employee (or the employee's spouse or dependent) has a significant curtailment that is a loss of coverage, the plan may permit that employee to revoke his or her election under the Cafeteria plan and, in lieu thereof, to elect either to receive on a prospective basis coverage under another benefit package option providing similar coverage or to drop coverage if no similar benefit package option is available. For purposes of this paragraph (f)(3)(ii), a loss of coverage means a complete loss of coverage under the benefit package option or other coverage option (including the elimination of a benefits package option, an HMO ceasing to be available in the area where the individual resides, or the individual losing all coverage under the option by reason of an overall lifetime or annual limitation). In addition, the cafeteria plan may, in its discretion, treat the following as a loss of coverage —

(A) A substantial decrease in the medical care providers available under the option (such as a major hospital ceasing to be a member of a preferred provider network or a substantial decrease in the physicians participating in a preferred provider network or an HMO);

(B) A reduction in the benefits for a specific type of medical condition or treatment with respect to which the employee or the employee's spouse or dependent is currently in a course of treatment; or

(C) Any other similar fundamental loss of coverage.

(iii) ***Addition or improvement of a benefit package option.*** **—**If a plan adds a new benefit package option or other coverage option, or if coverage under an existing benefit package option or other coverage option is significantly improved during a period of coverage, the cafeteria plan may permit eligible employees (whether or not they have previously made an election under the cafeteria plan or have previously elected the benefit package option) to revoke their election under the cafeteria plan and, in lieu thereof, to make an election on a prospective basis for coverage under the new or improved benefit package option.

(4) ***Change in coverage under another employer plan.*** **—**A cafeteria plan may permit an employee to make a prospective election change that is on account of and corresponds with a change made under another employer plan (including a plan of the same employer or of another employer) if —

(i) The other cafeteria plan or qualified benefits plan permits participants to make an election change that would be permitted under paragraphs (b) through (g) of this section (disregarding this paragraph (f)(4)); or

(ii) The cafeteria plan permits participants to make an election for a period of coverage that is different from the period of coverage under the other cafeteria plan or qualified benefits plan.

(5) ***Loss of coverage under other group health coverage.*** **—**A cafeteria plan may permit an employee to make an election on a prospective basis to add coverage under a cafeteria plan for the employee, spouse, or dependent if the employee, spouse, or dependent loses coverage under any group health coverage sponsored by a governmental or educational institution, including the following —

(i) A State's children's health insurance program (SCHIP) under Title XXI of the Social Security Act;

(ii) A medical care program of an Indian Tribal government (as defined in section 7701(a)(40)), the Indian Health Service, or a tribal organization;

(iii) A State health benefits risk pool; or

(iv) A Foreign government group health plan.

(6) ***Examples.*** **—**The following examples illustrate the application of this paragraph (f):

Example 1. (i) A calendar year cafeteria plan is maintained pursuant to a collective bargaining agreement for the benefit of Employer *M*'s employees. The cafeteria plan offers various benefits, including indemnity health insurance and a health FSA. As a result of mid-year negotiations, premiums for the indemnity health insurance are reduced in the middle of the year, insurance co-payments for office visits are reduced under the indemnity plan by an amount which constitutes a significant benefit improvement, and an HMO option is added.

(ii) Under these facts, the reduction in health insurance premiums is a reduction in cost. Accordingly, under paragraph (f)(2)(i) of this section, the cafeteria plan may automatically decrease the amount of salary reduction contributions of affected participants by an amount that corresponds to the premium change. However, the plan may not permit employees to change their health FSA elections to reflect the mid-year change in copayments under the indemnity plan.

(iii) Also, the decrease in co-payments is a significant benefit improvement and the addition of the HMO option is an addition of a benefit package option. Accordingly, under paragraph (f)(3)(ii) of this section, the cafeteria plan may permit eligible employees to make an election change to elect the indemnity plan or the new HMO option. However, the plan may not permit employees to change their health FSA elections to reflect differences in co-payments under the HMO option.

Example 2. (i) Employer *N* sponsors an accident or health plan under which employees may elect either employee-only coverage or family health coverage. The 12-month period of coverage under *N*'s cafeteria plan begins January 1, 2001. *N*'s employee, *A*, is married to *B*. Employee *A* elects employee-only coverage under *N*'s plan. *B*'s employer, *O*, offers health coverage to *O*'s employees under its accident or health plan under which employees may elect either employee-only coverage or family coverage. *O*'s plan has a 12-month period of coverage beginning September 1, 2001. *B* maintains individual coverage under *O*'s plan at the time *A* elects coverage under *N*'s plan, and wants to elect no coverage for the plan year beginning on September 1, 2001, which is the next period of coverage under *O*'s accident or health plan. *A* certifies to *N* that *B* will elect no coverage under *O*'s accident or health plan for the plan year beginning on September 1, 2001 and *N* has no reason to believe that *A*'s certification is incorrect.

(ii) Under paragraph (f)(4)(ii) of this section, *N*'s cafeteria plan may permit *A* to change *A*'s election prospectively to family coverage under that plan effective September 1, 2001.

Example 3. (i) Employer *P* sponsors a calendar year cafeteria plan under which employees may elect either employee-only or family health coverage. Before the beginning of the year, *P*'s employee, *C*, elects family coverage under *P*'s cafeteria plan. *C* also elects coverage under the health FSA for up to $200 of reimbursements for the year to be funded by salary reduction contributions of $200 during the year. *C* is married to *D*, who is employed by Employer *Q*. *Q* does not maintain a cafeteria plan, but does maintain an accident or health plan providing its employees with employee-only coverage. During the calendar year, *Q* adds family coverage as an option under its health plan. *D* elects family coverage under *Q*'s plan, and *C* wants to revoke *C*'s election for health coverage and elect no health coverage under *P*'s cafeteria plan for the remainder of the year.

(ii) *Q*'s addition of family coverage as an option under its health plan constitutes a new coverage option described in paragraph (f)(3)(ii) of this section. Accordingly, pursuant to paragraph (f)(4)(i) of this section, *P*'s cafeteria plan may permit *C* to revoke *C*'s health coverage election if *D* actually elects family health coverage under *Q*'s accident or health plan. Employer *P*'s plan may not permit *C* to change *C*'s health FSA election.

Example 4. (i) Employer *R* maintains a cafeteria plan under which employees may elect accident or health coverage under either an indemnity plan or an HMO. Before the beginning of the year, *R*'s employee, *E* elects coverage under the HMO at a premium cost of $100 per month. During the year, *E* decides to switch to the indemnity plan, which charges a premium of $140 per month.

(ii) *E*'s change from the HMO to indemnity plan is not a change in cost or coverage under this paragraph (f), and none of the other election change rules under paragraphs (b) through (e) of this section apply.

(iii) Although *R*'s health plan may permit *E* to make the change from the HMO to the indemnity plan, *R*'s cafeteria plan may not permit *E* to make an election change to reflect the increased premium. Accordingly, if *E* switches from the HMO to the indemnity plan, *E* may pay the $40 per month additional cost on an after-tax basis.

Example 5. (i) Employee *A* is married to Employee *B* and they have one child, *C*. Employee *A*'s employer, *M*, maintains a calendar year cafeteria plan that allows employees to elect coverage under a dependent care FSA. Child *C* attends *X*'s on site child care center at an annual cost of $3,000. Prior to the beginning of the year, *A* elects salary reduction contributions of $3,000 during the year to fund coverage under the dependent care FSA for up to $3,000 of reimbursements for the year. Employee *A* now wants to revoke *A*'s election of coverage under the dependent care FSA, because A has found a new child care provider.

(ii) The availability of dependent care services from the new child care provider (whether the new provider is a household employee or family member of *A* or *B* or a person who is independent of *A* and *B*) is a significant change in coverage similar to a benefit package option becoming available. Because the FSA is a dependent care FSA rather than a health FSA, the coverage rules of this section apply and *M*'s cafeteria plan may permit *A* to elect to revoke *A*'s previous election of coverage under the dependent care FSA, and make a corresponding new election to reflect the cost of the new child care provider.

Example 6. (i) Employee *D* is married to Employee *E* and they have one child, *F*. Employee *D*'s employer, *N*, maintains a calendar year cafeteria plan that allows employees to elect coverage under a dependent care FSA. Child *F* is cared for by *Y*, *D*'s household employee, who provides child care services five days a week from 9 a.m. to 6 p.m. at an annual cost in excess of $5,000. Prior to the beginning of the year, *D* elects salary reduction contributions of $5,000 during the year to fund coverage under the dependent care FSA for up to $5,000 of reimbursements for the year. During the year, *F* begins school and, as a result, *Y*'s regular hours of work are changed to five days a week from 3 p.m. to 6 p.m. Employee *D* now wants to revoke *D*'s election under the dependent care FSA, and make a new election under the dependent care FSA to an annual cost of $4,000 to reflect a reduced cost of child care due to *Y*'s reduced hours.

(ii) The change in the number of hours of work performed by *Y* is a change in coverage. Thus, *N*'s cafeteria plan may permit *D* to reduce *D*'s previous election under the dependent care FSA to $4,000.

Example 7. (i) Employee *G* is married to Employee *H* and they have one child, *J*. Employee *G*'s employer, *O*, maintains a calendar year cafeteria plan that allows employees to elect coverage under a dependent care FSA. Child *J* is cared for by *Z*, *G*'s household employee, who is not a relative of *G* and who provides child care services at an annual cost of $4,000. Prior to the beginning of the year, *G* elects salary reduction contributions of $4,000 during the year to fund coverage under the dependent care FSA for up to $4,000 of reimbursements for the year. During the year, *G* raises *Z*'s salary. Employee *G* now wants to revoke *G*'s election under the dependent care FSA, and make a new election under the dependent care FSA to an annual amount of $4,500 to reflect the raise.

(ii) The raise in *Z*'s salary is a significant increase in cost under paragraph (f)(2)(ii) of this section, and an increase in election to reflect the raise corresponds with that change in status. Thus, *O*'s cafeteria plan may permit *G* to elect to increase *G*'s election under the dependent care FSA.

Example 8. (i) Employer *P* maintains a calendar year cafeteria plan that allows employees to elect employee-only, employee plus one dependent, or family coverage under an indemnity plan. During the middle of the year, Employer *P* gives its employees the option to select employee-only or family coverage from an HMO plan. *P*'s employee, *J*, who had elected employee plus one dependent coverage under the indemnity plan, decides to switch to family coverage under the HMO plan.

(ii) Employer *P*'s midyear addition of the HMO option is an addition of a benefit package option. Under paragraph (f) of this section, Employee *J* may change his or her salary reduction contributions to reflect the change from indemnity to HMO coverage, and also to reflect the change from employee plus one dependent to family coverage (however, an election of employee-only coverage under the new option would not correspond with the addition of a new option). Employer *P* may not permit *J* to change *J*'s health FSA election.

(g) ***Special requirements relating to the Family and Medical Leave Act*. —**An employee taking leave under the Family and Medical Leave Act (FMLA) (Public Law 103-3 (107 Stat. 6)) may revoke an existing election of accident or health plan coverage and make such other election for the remaining portion of the period of coverage as may be provided for under the FMLA. See §1.125-3 for additional rules.

(h) ***Elective contributions under a qualified cash or deferred arrangement*. —**The provisions of this section do not apply with respect to elective contributions under a qualified cash or deferred arrangement (within the meaning of section 401(k)) or employee contributions subject to section 401(m). Thus, a cafeteria plan may permit an employee to modify or revoke elections in accordance with sections 401(k) and (m) and the regulations thereunder.

(i) ***Definitions*. —**Unless otherwise provided, the definitions in paragraphs (i)(1) though (8) of this section apply for purposes of this section.

(1) ***Accident or health coverage*. —**Accident or health coverage means coverage under an accident or health plan as defined in regulations under section 105.

(2) ***Benefit package option*. —**A benefit package option means a qualified benefit under section 125(f) that is offered under a cafeteria plan, or an option for coverage under an underlying accident or health plan (such as an indemnity option, an HMO option, or a PPO option under an accident or health plan).

(3) ***Dependent*. —**A dependent means a dependent as defined in section 152, except that, for purposes of accident or health coverage, any child to whom section 152(e) applies is treated as a dependent of both parents, and, for purposes of dependent care assistance provided through a cafeteria plan, a dependent means a qualifying individual (as defined in section 21(b)(1)) with respect to the employee.

(4) ***Disability coverage*. —**Disability coverage means coverage under an accident or health plan that provides benefits due to personal injury or sickness, but does not reimburse expenses incurred for medical care (as defined in section 213(d)) of the employee or the employee's spouse and dependents. For purposes of this section, disability coverage includes payments described in section 105(c).

(5) ***Family member plan*. —**A family member plan means a cafeteria plan or qualified benefit plan sponsored by the employer of the employee's spouse or the employee's dependent.

(6) ***FSA*, *health FSA*. —**An FSA means a qualified benefits plan that is a flexible spending arrangement as defined in section 106(c)(2) . A health FSA means a health or accident plan that is an FSA.

(7) ***Placement for adoption*. —**Placement for adoption means placement for adoption as defined in regulations under section 9801.

(8) ***Qualified benefits plan*. —**A qualified benefits plan means an employee benefit plan governing the provision of one or more benefits that are qualified benefits under section 125(f). A plan does not fail to be a qualified benefits plan merely because it includes an FSA, assuming that the FSA meets the requirements of section 125 and the regulations thereunder.

(9) ***Similar coverage*. —**Coverage for the same category of benefits for the same individuals (e.g., family to family or single to single). For example, two plans that provide coverage for major medical are considered to be similar coverage. For purposes of this definition, a health FSA is not similar coverage with respect to an accident or health plan that is not a health FSA. A plan may treat coverage by another employer, such as a spouse's or dependent's employer, as similar coverage.

(j) ***Effective date***

(1) ***General rule*. —**Except as provided in paragraph (j)(2) of this section, this section is applicable for cafeteria plan years beginning on or after January 1, 2001.

(2) ***Delayed effective date for certain provisions*. —**The following provisions are applicable for cafeteria plan years beginning on or after January 1, 2002: paragraph (c) of this section to the extent applicable to qualified benefits other than an accident or health plan or a group-term life insurance plan; paragraph (d)(1)(ii)(B) of this section (relating to a spouse, former spouse, or other individual obtaining accident or health coverage for an employee's child in response to a judgment, decree, or order); paragraph (f) of this section (rules for election changes as a result of cost or coverage changes); and paragraph (i)(9) of this section (defining similar coverage). [Reg. §1.125-4.]

.01 Historical Comment: Adopted 3/22/2000 by T.D. 8878. Amended 1/9/2001 by T.D. 8921 (corrected 3/1/2001) and 10/16/2001 by T.D. 8966.

PROP-REG, 2007FED ¶7323F, §1.125-5., **Flexible spending arrangements, REG-142695-05, 8/6/2007.**

Flexible spending arrangements, REG-142695-05, 8/6/2007.

(a) ***Definition of flexible spending arrangement***

(1) ***In general*. —**An FSA generally is a benefit program that provides employees with coverage which reimburses specified, incurred expenses (subject to reimbursement maximums and any other reasonable conditions). An expense for qualified benefits must not be reimbursed from the FSA unless it is incurred during a period of coverage. See paragraph (e) of this section. After an expense for a qualified benefit has been incurred, the expense must first be substantiated before the expense is reimbursed. See paragraphs (a) through (f) in §1.125-6.

(2) ***Maximum amount of reimbursement.*** **—**The maximum amount of reimbursement that is reasonably available to an employee for a period of coverage must not be substantially in excess of the total salary reduction and employer flex-credit for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total salary reduction and employer flex-credit if such maximum amount is less than 500 percent of the combined salary reduction and employer flex-credit. A single FSA may provide participants with different levels of coverage and maximum amounts of reimbursement. See paragraph (r) in §1.125-1 and paragraphs (b) and (d) in this section for the definition of salary reduction, employer flex-credit, and uniform coverage rule.

(b) ***Flex-credits allowed***

(1) ***In general.*** **—**An FSA in a cafeteria plan must include an election between cash or taxable benefits (including salary reduction) and one or more qualified benefits, and may include, in addition, "employer flex-credits." For this purpose, flex-credits are non-elective employer contributions that the employer makes for every employee eligible to participate in the employer's cafeteria plan, to be used at the employee's election only for one or more qualified benefits (but not as cash or a taxable benefit). See §1.125-1 for definitions of qualified benefits, cash and taxable benefits.

(2) ***Example.*** **—**The following example illustrates the rules in this paragraph (b):

Example. *Flex-credit*. *Contribution to health FSA for employees electing employer-provided accident and health plan*. Employer A maintains a cafeteria plan offering employees an election between cash or taxable benefits and premiums for employer-provided accident and health insurance or coverage through an HMO. The plan also provides an employer contribution of $200 to the health FSA of every employee who elects accident and health insurance or HMO coverage. In addition, these employees may elect to reduce their salary to make additional contributions to their health FSAs. The benefits offered in this cafeteria plan are consistent with the requirements of section 125 and this paragraph (b).

(c) ***Use-or-lose rule***

(1) ***In general.*** **—**An FSA may not defer compensation. No contribution or benefit from an FSA may be carried over to any subsequent plan year or period of coverage. See paragraph (k)(3) in this section for specific exceptions. Unused benefits or contributions remaining at the end of the plan year (or at the end of a grace period, if applicable) are forfeited.

(2) ***Example.*** **—**The following example illustrates the rules in this paragraph (c):

Example. *Use-or-lose rule*. (i) Employer B maintains a calendar year cafeteria plan, offering an election between cash and a health FSA. The cafeteria plan has no grace period.

(ii) Employee A plans to have eye surgery in 2009. For the 2009 plan year, Employee A timely elects salary reduction of $3,000 for a health FSA. During the 2009 plan year, Employee A learns that she cannot have eye surgery performed, but incurs other section 213(d) medical expenses totaling $1,200. As of December 31, 2009, she has $1,800 of unused benefits and contributions in the health FSA. Consistent with the rules in this paragraph (c), she forfeits $1,800.

(d) ***Uniform coverage rules applicable to health FSAs***

(1) ***Uniform coverage throughout coverage period- in general.*** **—**The maximum amount of reimbursement from a health FSA must be available at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage). Thus, the maximum amount of reimbursement at any particular time during the period of coverage cannot relate to the amount that has been contributed to the FSA at any particular time prior to the end of the plan year. Similarly, the payment schedule for the required amount for coverage under a health FSA may not be based on the rate or amount of covered claims incurred during the coverage period. Employees' salary reduction payments must not be accelerated based on employees' incurred claims and reimbursements.

(2) ***Reimbursement available at all times.*** **—**Reimbursement is deemed to be available at all times if it is paid at least monthly or when the total amount of the claims to be submitted is at least a specified, reasonable minimum amount (for example, $50).

(3) ***Terminated participants.*** **—**When an employee ceases to be a participant, the cafeteria plan must pay the former participant any amount the former participant previously paid for coverage or benefits to the extent the previously paid amount relates to the period from the date the employee ceases to be a participant through the end of that plan year. See paragraph (e)(2) in this section for COBRA elections for health FSAs.

(4) ***Example.*** **—**The following example illustrates the rules in this paragraph (d):

Example. *Uniform coverage*. (i) Employer C maintains a calendar year cafeteria plan, offering an election between cash and a health FSA. The cafeteria plan prohibits accelerating employees' salary reduction payments based on employees' incurred claims and reimbursements.

(ii) For the 2009 plan year, Employee N timely elects salary reduction of $3,000 for a health FSA. Employee N pays the $3,000 salary reduction amount through salary reduction of $250 per month throughout the coverage period. Employee N is eligible to receive the maximum amount of reimbursement of $3,000 at all times throughout the coverage period (reduced by prior reimbursements).

(iii) N incurs $2,500 of section 213(d) medical expenses in January, 2009. The full $2,500 is reimbursed although Employee N has made only one salary reduction payment of $250. N incurs $500 in medical expenses in February, 2009. The remaining $500 of the $3,000 is reimbursed. After Employee N submits a claim for reimbursement and substantiates the medical expenses, the cafeteria plan reimburses N for the $2,500 and $500 medical expenses. Employer C's cafeteria plan satisfies the uniform coverage rule.

(5) ***No uniform coverage rule for FSAs for dependent care assistance or adoption assistance.*** **—**The uniform coverage rule applies only to health FSAs and does not apply to FSAs for dependent care assistance or adoption assistance. See paragraphs (i) and (j) of this section for the rules for FSAs for dependent care assistance and adoption assistance.

(e) ***Required period of coverage for a health FSA, dependent care FSA and adoption assistance FSA***

(1) ***Twelve-month period of coverage —in general.*** **—**An FSA's period of coverage must be 12 months. However, in the case of a short plan year, the period of coverage is the entire short plan year. See paragraph (d) in §1.125-1 for rules on plan years and changing plan years.

(2) ***COBRA elections for health FSAs.*** **—**For the application of the health care continuation rules of section 4980B of the Code to health FSAs, see Q & A-2 in §54.4980B-2 of this chapter.

(3) ***Separate period of coverage permitted for each qualified benefit offered through FSA.*** **—**Dependent care assistance, adoption assistance, and a health FSA are each permitted to have a separate period of coverage, which may be different from the plan year of the cafeteria plan.

(f) ***Coverage on a month-by-month or expense-by-expense basis prohibited.*** **—**In order for reimbursements from an accident and health plan to qualify for the section 105(b) exclusion, an employer-funded accident and health plan offered through a cafeteria plan may not operate in a manner that enables employees to purchase the accident and health plan coverage only for periods when employees expect to incur medical care expenses. Thus, for example, if a cafeteria plan permits employees to receive accident and health plan coverage on a month-by-month or an expense-by-expense basis, reimbursements from the accident and health plan fail to qualify for the section 105(b) exclusion. If, however, the period of coverage under an accident and health plan offered through a cafeteria plan is twelve months and the cafeteria plan does not permit an employee to elect specific amounts of coverage, reimbursement, or salary reduction for less than twelve months, the cafeteria plan does not operate to enable participants to purchase coverage only for periods during which medical care will be incurred. See §1.125-4 and paragraph (a) in §1.125-2 regarding the revocation of elections during a period of coverage on account of changes in family status.

(g) ***FSA administrative practices***

(1) ***Limiting health FSA enrollment to employees who participate in the employer's accident and health plan.*** **—**At the employer's option, a cafeteria plan is permitted to provide that only those employees who participate in one or more specified employer-provided accident and health plans may participate in a health FSA. See §1.125-7 for nondiscrimination rules.

(2) ***Interval for employees' salary reduction contributions.*** **—**The cafeteria plan is permitted to specify any interval for employees' salary reduction contributions. The interval specified in the plan must be uniform for all participants.

(h) ***Qualified benefits permitted to be offered through an FSA.*** **—**Dependent care assistance (section 129), adoption assistance (section 137) and a medical reimbursement arrangement (section 105(b)) are permitted to be offered through an FSA in a cafeteria plan.

(i) ***Section 129 rules for dependent care assistance program offered through a cafeteria plan***

(1) ***General rule.*** **—**In order for dependent care assistance to be a qualified benefit that is excludible from gross income if elected through a cafeteria plan, the cafeteria plan must satisfy section 125 and the dependent care assistance must satisfy section 129.

(2) ***Dependent care assistance in general.*** **—**Section 129(a) provides an employee with an exclusion from gross income both for an employer-funded dependent care assistance program and for amounts paid or incurred by the employer for dependent care assistance provided to the employee, if the amounts are paid or incurred through a dependent care assistance program. See paragraph (a)(4) in §1.125-6 on when dependent care expenses are incurred.

(3) ***Reimbursement exclusively for dependent care assistance.*** **—**A dependent care assistance program may not provide reimbursements other than for dependent care expenses; in particular, if an employee has dependent care expenses less than the amount specified by salary reduction, the plan may not provide other taxable or nontaxable benefits for any portion of the specified amount not used for the reimbursement of dependent care expenses. Thus, if an employee has elected coverage under the dependent care assistance program and the period of coverage has commenced, the employee must not have the right to receive amounts from the program other than as reimbursements for dependent care expenses. This is the case regardless of whether coverage under the program is purchased with contributions made at the employer's discretion, at the employee's discretion, or pursuant to a collective bargaining agreement. Arrangements formally outside of the cafeteria plan providing for the adjustment of an employee's compensation or an employee's receipt of any other benefits on the basis of the assistance or reimbursements received by the employee are considered in determining whether a dependent care benefit is a dependent care assistance program under section 129.

(j) ***Section 137 rules for adoption assistance program offered through a cafeteria plan***

(1) ***General rule.*** **—**In order for adoption assistance to be a qualified benefit that is excludible from gross income if elected through a cafeteria plan, the cafeteria plan must satisfy section 125 and the adoption assistance must satisfy section 137.

(2) ***Adoption assistance in general.*** **—**Section 137(a) provides an employee with an exclusion from gross income for amounts paid or expenses incurred by the employer for qualified adoption expenses in connection with an employee's adoption of a child, if the amounts are paid or incurred through an adoption assistance program. Certain limits on amount of expenses and employee's income apply.

(3) ***Reimbursement exclusively for adoption assistance.*** **—**Rules and requirements similar to the rules and requirements in paragraph (i)(3) of this section for dependent care assistance apply to adoption assistance.

(k) ***FSAs and the rules governing the tax-favored treatment of employer-provided health benefits***

(1) ***Medical expenses.*** **—**Health plans that are flexible spending arrangements, as defined in paragraph (a)(1) of this section, must conform to the generally applicable rules under sections 105 and 106 in order for the coverage and reimbursements under such plans to qualify for tax-favored treatment under such sections. Thus, health FSAs must qualify as accident and health plans. See paragraph (n) in §1.125-1. A health FSA is only permitted to reimburse medical expenses as defined in section 213(d). Thus, for example, a health FSA is not permitted to reimburse dependent care expenses.

(2) ***Limiting payment or reimbursement to certain section 213(d) medical expenses.*** **—**A health FSA is permitted to limit payment or reimbursement to only certain section 213(d) medical expenses (except health insurance, long-term care services or insurance). See paragraph (q) in §1.125-1. For example, a health FSA in a cafeteria plan is permitted to provide in the written plan that the plan reimburses all section 213(d) medical expenses allowed to be paid or reimbursed under a cafeteria plan except over-the-counter drugs.

(3) ***Application of prohibition against deferred compensation to medical expenses***

(i) ***Certain advance payments for orthodontia permitted.*** **—**A cafeteria plan is permitted, but is not required to, reimburse employees for orthodontia services before the services are provided but only to the extent that the employee has actually made the payments in advance of the orthodontia services in order to receive the services. These orthodontia services are deemed to be incurred when the employee makes the advance payment. Reimbursing advance payments does not violate the prohibition against deferring compensation.

(ii) ***Example.*** **—**The following example illustrates the rules in paragraph (k)(3):

Example. *Advance payment to orthodontist*. Employer D sponsors a calendar year cafeteria plan which offers a health FSA. Employee K elects to salary reduce $3,000 for a health FSA for the 2009 plan year. Employee K's dependent requires orthodontic treatment. K's accident and health insurance does not cover orthodontia. The orthodontist, following the normal practice, charges $3,000, all due in 2009, for treatment, to begin in 2009 and end in 2010. K pays the $3,000 in 2009. In 2009, Employer D's cafeteria plan may reimburse $3,000 to K, without violating the prohibition against deferring compensation in section 125(d)(2).

(ii) ***Reimbursements for durable medical equipment.*** **—**A health FSA in a cafeteria plan that reimburses employees for equipment (described in section 213(d)) with a useful life extending beyond the period of coverage during which the expense is incurred does not provide deferred compensation. For example, a health FSA is permitted to reimburse the cost of a wheelchair for an employee.

(4) ***No reimbursement of premiums for accident and health insurance or long-term care insurance or services.*** **—**A health FSA is not permitted to treat employees' premium payments for other health coverage as reimbursable expenses. Thus, for example, a health FSA is not permitted to reimburse employees for payments for other health plan coverage, including premiums for COBRA coverage, accidental death and dismemberment insurance, long-term disability or short-term disability insurance or for health coverage under a plan maintained by the employer of the employee or the employer of the employee's spouse or dependent. Also, a health FSA is not permitted to reimburse expenses for long-term care insurance premiums or for long-term care services for the employee or employee's spouse or dependent. See paragraph (q) in §1.125-1 for nonqualified benefits

(l) ***Section 105(h) requirements.*** **—**Section 105(h) applies to health FSAs. Section 105(h) provides that the exclusion provided by section 105(b) is not available with respect to certain amounts received by a highly compensated individual (as defined in section 105(h)(5)) from a discriminatory self-insured medical reimbursement plan, which includes health FSAs. See §1.105-11. For purposes of section 105(h), coverage by a self-insured accident and health plan offered through a cafeteria plan is an optional benefit (even if only one level and type of coverage is offered) and, for purposes of the optional benefit rule in §1.105-11(c)(3)(i), employer contributions are treated as employee contributions to the extent that taxable benefits are offered by the plan.

(m) ***HSA-compatible FSAs-limited-purpose health FSAs and post-deductible health FSAs***

(1) ***In general.*** **—***Limited-purpose health FSAs* and *post-deductible health FSAs* which satisfy all the requirements of section 125 are permitted to be offered through a cafeteria plan.

(2) ***HSA-compatible FSAs.*** **—**Section 223(a) allows a deduction for certain contributions to a “Health Savings Account” (HSA) (as defined in section 223(d)). An *eligible individual* (as defined in section 223(c)(1)) may contribute to an HSA. An eligible individual must be covered under a “high deductible health plan” (HDHP) and not, while covered under an HDHP, under any health plan which is not an HDHP. A general purpose health FSA is not an HDHP and an individual covered by a general purpose health FSA is not eligible to contribute to an HSA. However, an individual covered by an HDHP (and who otherwise satisfies section 223(c)(1)) does not fail to be an eligible individual merely because the individual is also covered by a limited-purpose health FSA or post-deductible health FSA (as defined in this paragraph (m)) or a combination of a limited-purpose health FSA and a post-deductible health FSA.

(3) ***Limited-purpose health FSA.*** **—**A limited-purpose health FSA is a health FSA described in the cafeteria plan that only pays or reimburses permitted coverage benefits (as defined in section 223(c)(2)(C)), such as vision care, dental care or preventive care (as defined for purposes of section 223(c)(2)(C)). See paragraph (k) in this section.

(4) ***Post-deductible health FSA***

(i) ***In general.*** **—**A post-deductible health FSA is a health FSA described in the cafeteria plan that only pays or reimburses medical expenses (as defined in section 213(d)) for preventive care or medical expenses incurred after the minimum annual HDHP deductible under section 223(c)(2)(A)(i) is satisfied. See paragraph (k) in this section. No medical expenses incurred before the annual HDHP deductible is satisfied may be reimbursed by a post-deductible FSA, regardless of whether the HDHP covers the expense or whether the deductible is later satisfied. For example, even if chiropractic care is not covered under the HDHP, expenses for chiropractic care incurred before the HDHP deductible is satisfied are not reimbursable at any time by a post-deductible health FSA.

(ii) ***HDHP and health FSA deductibles.*** **—**The deductible for a post-deductible health FSA need not be the same amount as the deductible for the HDHP, but in no event may the post-deductible health FSA or other coverage provide benefits before the minimum annual HDHP deductible under section 223(c)(2)(A)(i) is satisfied (other than benefits permitted under a limited-purpose health FSA). In addition, although the deductibles of the HDHP and the other coverage may be satisfied independently by separate expenses, no benefits may be paid before the minimum annual deductible under section 223(c)(2)(A)(i) has been satisfied. An individual covered by a post-deductible health FSA (if otherwise an eligible individual) is an eligible individual for the purpose of contributing to the HSA.

(5) ***Combination of limited-purpose health FSA and post-deductible health FSA.*** **—**An FSA is a combination of a limited-purpose health FSA and post-deductible health FSA if each of the benefits and reimbursements provided under the FSA are permitted under either a limited-purpose health FSA or post-deductible health FSA. For example, before the HDHP deductible is satisfied, a combination limited-purpose and post-deductible health FSA may reimburse only preventive, vision or dental expenses. A combination limited-purpose and post-deductible health FSA may also reimburse any medical expense that may otherwise be paid by an FSA (that is, no insurance premiums or long-term care benefits) that is incurred after the HDHP deductible is satisfied.

(6) ***Substantiation*****. —**The substantiation rules in this section apply to limited-purpose health FSAs and to post-deductible health FSAs. In addition to providing third-party substantiation of medical expenses, a participant in a post-deductible health FSA must provide information from an independent third party that the HDHP deductible has been satisfied. A participant in a limited-purpose health FSA must provide information from an independent third-party that the medical expenses are for vision care, dental care or preventive care.

(7) ***Plan amendments*****. —**See paragraph (c) in §1.125-1 on the required effective date for amendments adopting or changing limited-purpose, post-deductible or combination limited-purpose and post-deductible health FSAs.

(n) ***Qualified HSA distributions***

(1) ***In general*****. —**A health FSA in a cafeteria plan is permitted to offer employees the right to elect qualified HSA distributions described in section 106(e). No qualified HSA distribution may be made in a plan year unless the employer amends the health FSA written plan with respect to all employees, effective by the last day of the plan year, to allow a qualified HSA distribution satisfying all the requirements in this paragraph (n). See also section 106(e)(5)(B). In addition, a distribution with respect to an employee is not a qualified HSA distribution unless all of the following the requirements are satisfied —

(i) No qualified HSA distribution has been previously made on behalf of the employee from this health FSA;

(ii) The employee elects to have the employer make a qualified HSA distribution from the health FSA to the HSA of the employee;

(iii) The distribution does not exceed the lesser of the balance of the health FSA on- -

(A) September 21, 2006; or

(B) The date of the distribution;

(iv) For purposes of this paragraph (n)(1), balances as of any date are determined on a cash basis, without taking into account expenses incurred but not reimbursed as of a date, and applying the uniform coverage rule in paragraph (d) in this section;

(v) The distribution is made no later than December 31, 2011; and

(vi) The employer makes the distribution directly to the trustee of the employee's HSA.

(2) ***Taxation of qualified HSA distributions*****. —**A qualified HSA distribution from the health FSA covering the participant to his or her HSA is a rollover to the HSA (as defined in section 223(f)(5)) and thus is generally not includible in gross income. However, if the participant is not an eligible individual (as defined in section 223(c)(1)) at any time during a testing period following the qualified HSA distribution, the amount of the distribution is includible in the participant's gross income and he or she is also subject to an additional 10 percent tax (with certain exceptions). Section 106(e)(3).

(3) ***No effect on health FSA elections, coverage, use-or-lose rule*****. —**A qualified HSA distribution does not alter an employee's irrevocable election under paragraph (a) of §1.125-2, or constitute a change in status under §1.125-4(a). If a qualified HSA distribution is made to an employee's HSA, even if the balance in a health FSA is reduced to zero, the employee's health FSA coverage continues to the end of the plan year. Unused benefits and contributions remaining at the end of a plan year (or at the end of a grace period, if applicable) must be forfeited.

(o) ***FSA experience gains or forfeitures***

(1) ***Experience gains in general*****. —**An FSA experience gain (sometimes referred to as forfeitures in the use-or-lose rule in paragraph (c) in this section) with respect to a plan year (plus any grace period following the end of a plan year described in paragraph (e) in §1.125-1), equals the amount of the employer contributions, including salary reduction contributions, and after-tax employee contributions to the FSA minus the FSA's total claims reimbursements for the year. Experience gains (or forfeitures) may be —

(i) Retained by the employer maintaining the cafeteria plan; or

(ii) If not retained by the employer, may be used only in one or more of the following ways - -

(A) To reduce required salary reduction amounts for the immediately following plan year, on a reasonable and uniform basis, as described in paragraph (o)(2) of this section;

(B) Returned to the employees on a reasonable and uniform basis, as described in paragraph (o)(2) of this section; or

(C) To defray expenses to administer the cafeteria plan.

(2) ***Allocating experience gains among employees on reasonable and uniform basis*****. —**If not retained by the employer or used to defray expenses of administering the plan, the experience gains must be allocated among employees on a reasonable and uniform basis. It is permissible to allocate these amounts based on the different coverage levels of employees under the FSA. Experience gains allocated in compliance with this paragraph (o) are not a deferral of the receipt of compensation. However, in no case may the experience gains be allocated among employees based (directly or indirectly) on their individual claims experience. Experience gains may not be used as contributions directly or indirectly to any deferred compensation benefit plan.

(3) ***Example*****. —**The following example illustrates the rules in this paragraph (o):

Example. *Allocating experience gains*. (i) Employer L maintains a cafeteria plan for its 1,200 employees, who may elect one of several different annual coverage levels under a health FSA in $100 increments from $500 to $2,000.

(ii) For the 2009 plan year, 1,000 employees elect levels of coverage under the health FSA. For the 2009 plan year, the health FSA has an experience gain of $5,000.

(iii) The $5,000 may be allocated to all participants for the plan year on a per capita basis weighted to reflect the participants' elected levels of coverage.

(iv) Alternatively, the $5,000 may be used to reduce the required salary reduction amount under the health FSA for all 2009 participants (for example, a $500 health FSA for the next year is priced at $480) or to reimburse claims incurred above the elective limit in 2010 as long as such reimbursements are made on a reasonable and uniform level.

(p) ***Effective/applicability date*****. —**It is proposed that these regulations apply on and after plan years beginning on or after January 1, 2009. [Reg. §1.125-5.]

PROP-REG, 2007FED ¶7323G, §1.125-6., **Substantiation of expenses for all cafeteria plans, REG-142695-05, 8/6/2007.**

Substantiation of expenses for all cafeteria plans, REG-142695-05, 8/6/2007.

(a) ***Cafeteria plan payments and reimbursements***

(1) ***In general*****. —**A cafeteria plan may pay or reimburse only those substantiated expenses for qualified benefits incurred on or after the later of the effective date of the cafeteria plan and the date the employee is enrolled in the plan. This requirement applies to all qualified benefits offered through the cafeteria plan. See paragraph (b) of this section for substantiation rules.

(2) ***Expenses incurred***

(i) ***Employees' medical expenses must be incurred during the period of coverage*****. —**In order for reimbursements to be excludible from gross income under section 105(b), the medical expenses reimbursed by an accident and health plan elected through a cafeteria plan must be incurred during the period when the participant is covered by the accident and health plan. A participant's period of coverage includes COBRA coverage. See §54.4980B-2 of this chapter. Medical expenses incurred before the later of the effective date of the plan and the date the employee is enrolled in the plan are not incurred during the period for which the employee is covered by the plan. However, the actual reimbursement of covered medical care expenses may be made after the applicable period of coverage.

(ii) ***When medical expenses are incurred*****. —**For purposes of this rule, medical expenses are incurred when the employee (or the employee's spouse or dependents) is provided with the medical care that gives rise to the medical expenses, and not when the employee is formally billed, charged for, or pays for the medical care.

(iii) ***Example*****. —**The following example illustrates the rules in this paragraph (a)(2):

Example. *Medical expenses incurred after termination*. (i) Employer E maintains a cafeteria plan with a calendar year plan year. The cafeteria plan provides that participation terminates when an individual ceases to be an employee of Employer E, unless the former employee elects to continue to participate in the health FSA under the COBRA rules in §54.4980B- 2 of this chapter. Employee G timely elects to salary reduce $1,200 to participate in a health FSA for the 2009 plan year. As of June 30, 2009, Employee G has contributed $600 toward the health FSA, but incurred no medical expenses. On June 30, 2009, Employee G terminates employment and does not continue participation under COBRA. On July 15, 2009, G incurs a section 213(d) medical expense of $500.

(ii) Under the rules in paragraph (a)(2) of this section, the cafeteria plan is prohibited from reimbursing any portion of the $500 medical expense because, at the time the medical expense is incurred, G is not a participant in the cafeteria plan.

(3) ***Section 105(b) requirements for reimbursement of medical expenses through a cafeteria plan***

(i) ***In general*****. —**In order for medical care reimbursements paid to an employee through a cafeteria plan to be excludible under section 105(b), the reimbursements must be paid pursuant to an employer-funded *accident and health plan*, as defined in section 105(e) and §§1.105-2 and 1.105-5.

(ii) ***Reimbursement exclusively for section 213(d) medical expenses*****. —**A cafeteria plan benefit through which an employee receives reimbursements of medical expenses is excludable under section 105(b) only if reimbursements from the plan are made specifically to reimburse the employee for medical expenses (as defined in section 213(d)) incurred by the employee or the employee's spouse or dependents during the period of coverage. Amounts paid to an employee as reimbursement are not paid specifically to reimburse the employee for medical expenses if the plan provides that the employee is entitled, or operates in a manner that entitles the employee, to receive the amounts, in the form of cash (for example, routine payment of salary) or any other taxable or nontaxable benefit irrespective of whether the employee (or the employee's spouse or dependents) incurs medical expenses during the period of coverage. This rule applies even if the employee will not receive such amounts until the end or after the end of the period. A plan under which employees (or their spouses and dependents) will receive reimbursement for medical expenses up to a specified amount and, if they incur no medical expenses, will receive cash or any other benefit in lieu of the reimbursements is not a benefit qualifying for the exclusion under sections 106 and 105(b). See §1.105-2. This is the case without regard to whether the benefit was purchased with contributions made at the employer's discretion, at the employee's discretion (for example, by salary reduction election), or pursuant to a collective bargaining agreement.

(iii) ***Other arrangements*****. —**Arrangements formally outside of the cafeteria plan that adjust an employee's compensation or an employee's receipt of any other benefits on the basis of the expenses incurred or reimbursements the employee receives are considered in determining whether the reimbursements are through a plan eligible for the exclusions under sections 106 and 105(b).

(4) ***Reimbursements of dependent care expenses***

(i) ***Dependent care expenses must be incurred*****. —**In order to satisfy section 129, dependent care expenses may not be reimbursed before the expenses are incurred. For purposes of this rule, dependent care expenses are incurred when the care is provided and not when the employee is formally billed, charged for, or pays for the dependent care.

(ii) ***Dependent care provided during the period of coverage*. —**In order for dependent care assistance to be provided through a dependent care assistance program eligible for the section 129 exclusion, the care must be provided to or on behalf of the employee during the period for which the employee is covered by the program. For example, if for a plan year, an employee elects a dependent care assistance program providing for reimbursement of dependent care expenses, only reimbursements for dependent care expenses incurred during that plan year are provided from a dependent care assistance program within the scope of section 129. Also, for purposes of this rule, expenses incurred before the later of the program's effective date and the date the employee is enrolled in the program are not incurred during the period when the employee is covered by the program. Similarly, if the dependent care assistance program furnishes the dependent care in-kind (for example, through an employer-maintained child care facility), only dependent care provided during the plan year of coverage is provided through a dependent care assistance program within the meaning of section 129. See also §1.125-5 for FSA rules.

(iii) ***Period of coverage*. —**In order for dependent care assistance through a cafeteria plan to be provided through a dependent care assistance program eligible for the section 129 exclusion, the plan may not operate in a manner that enables employees to purchase dependent care assistance only for periods during which the employees expect to receive dependent care assistance. If the period of coverage for a dependent care assistance program offered through a cafeteria plan is twelve months (or, in the case of a short plan year, at least equal to the short plan year) and the plan does not permit an employee to elect specific amounts of coverage, reimbursement, or salary reduction for less than twelve months, the plan is deemed not to operate to enable employees to purchase coverage only for periods when dependent care assistance will be received. See paragraph (a) in §1.125-2 and §1.125-4 regarding the revocation of elections during the period of coverage on account of changes in family status. See paragraph (e) in this section for required period of coverage for dependent care assistance.

(iv) ***Examples*. —**The following examples illustrate the rules in paragraphs (a)(4)(i)-(iii) of this section:

Example 1. *Initial non-refundable fee for child care*. (i) Employer F maintains a calendar year cafeteria plan, offering employees an election between cash and qualified benefits, including dependent care assistance. Employee M has a one-year old dependent child. Employee M timely elected $5,000 of dependent care assistance for 2009. During the entire 2009 plan year, Employee M satisfies all the requirements in section 129 for dependent care assistance.

(ii) On February 1, 2009, Employee M pays an initial non-refundable fee of $500 to a licensed child care center (unrelated to Employer F or to Employee M), to reserve a space at the child care center for M's child. The child care center's monthly charges for child care are $1,200. When the child care center first begins to care for M's child, the $500 non-refundable fee is applied toward the first month's charges for child care.

(iii) On March 1, 2009, the child care center begins caring for Employee M's child, and continues to care for the child through December 31, 2009. On March 1, 2009, M pays the child care center $700 (the balance of the $1,200 in charges for child care to be provided in March 2009). On April 1, 2009, M pays the child care center $1,200 for the child care to be provided in April 2009.

(iv) Dependent care expenses are incurred when the services are provided. For dependent care services provided in March 2009, the $500 nonrefundable fee paid on February 1, 2009, and the $700 paid on March 1, 2009 may be reimbursed on or after the later of the date when substantiated or April 1, 2009. For dependent care services provided in April 2009, the $1,200 paid on April 1, 2009 may be reimbursed on or after the later of the date when substantiated or May 1, 2009.

Example 2. *Non-refundable fee forfeited*. Same facts as *Example 1*, except that the child care center never cared for M's child (who was instead cared for at Employer F's onsite child care facility). Because the child care center never provided child care services to Employee M's child, the $500 non-refundable fee is not reimbursable.

(v) ***Optional spend-down provision*. —**At the employer's option, the written cafeteria plan may provide that dependent care expenses incurred after the date an employee ceases participation in the cafeteria plan (for example, after termination) and through the last day of that plan year (or grace period immediately after that plan year) may be reimbursed from unused benefits, if all of the requirements of section 129 are satisfied.

(vi) ***Example*. —**The following example illustrates the rules in paragraph (a)(4)(v) of this section:

Example. *Terminated employee's post-termination dependent care expenses*. (i) For calendar year 2009, Employee X elects $5,000 salary reduction for dependent care assistance through Employer G's cafeteria plan. X works for Employer G from January 1 through June 30, 2009, when X terminates employment. As of June 30, 2009, X had paid $2,500 in salary reduction and had incurred and was reimbursed for $2,000 of dependent care expenses.

(ii) X does not work again until October 1, 2009, when X begins work for Employer H. X was employed by Employer H from October 1, 2009 through December 31, 2009. During this period, X also incurred $500 of dependent care expenses. During all the periods of employment in 2009, X satisfied all requirements in section 129 for excluding payments for dependent care assistance from gross income.

(iii) Employer G's cafeteria plan allows terminated employees to "spend down" unused salary reduction amounts for dependent care assistance, if all requirements of section 129 are satisfied. After X's claim for $500 of dependent care expenses is substantiated, Employer G's cafeteria plan reimburses X for $500 (the remaining balance) of dependent care expenses incurred during X's employment for Employer H between October 1, 2009 and December 31, 2009. Employer G's cafeteria plan and operation are consistent with section 125.

(b) ***Rules for claims substantiation for cafeteria plans***

(1) ***Substantiation required before reimbursing expenses for qualified benefits*. —**This paragraph (b) sets forth the substantiation requirements that a cafeteria plan must satisfy before paying or reimbursing any expense for a qualified benefit.

(2) ***All claims must be substantiated*. —**As a precondition of payment or reimbursement of expenses for qualified benefits, a cafeteria plan must require substantiation in accordance with this section. Substantiating only a percentage of claims, or substantiating only claims above a certain dollar amount, fails to comply with the substantiation requirements in §1.125-1 and this section.

(3) ***Substantiation by independent third-party***

(i) ***In general.*** **—**All expenses must be substantiated by information from a third-party that is independent of the employee and the employee's spouse and dependents. The independent third-party must provide information describing the service or product, the date of the service or sale, and the amount. Self-substantiation or self-certification of an expense by an employee does not satisfy the substantiation requirements of this paragraph (b). The specific requirements in sections 105(b), 129, and 137 must also be satisfied as a condition of reimbursing expenses for qualified benefits. For example, a health FSA does not satisfy the requirements of section 105(b) if it reimburses employees for expenses where the employees only submit information describing medical expenses, the amount of the expenses and the date of the expenses but fail to provide a statement from an independent third-party (either automatically or subsequent to the transaction) verifying the expenses. Under §1.105-2, all amounts paid under a plan that permits self-substantiation or self-certification are includible in gross income, including amounts reimbursed for medical expenses, whether or not substantiated. See paragraph (m) in §1.125-5 for additional substantiation rules for limited-purpose and post-deductible health FSAs.

(ii) ***Rules for substantiation of health FSA claims using an explanation of benefits provided by an insurance company***

(A) ***Written statement from an independent third-party.*** **—**If the employer is provided with information from an independent third-party (such as an "*explanation of benefits*" (*EOB*) from an insurance company) indicating the date of the section 213(d) medical care and the employee's responsibility for payment for that medical care (that is, coinsurance payments and amounts below the plan's deductible), and the employee certifies that any expense paid through the health FSA has not been reimbursed and that the employee will not seek reimbursement from any other plan covering health benefits, the claim is fully substantiated without the need for submission of a receipt by the employee or further review.

(B) ***Example.*** **—**The following example illustrates the rules in this paragraph (b)(3):

Example.Explanation of benefits. (i) During the plan year ending December 31, 2009, Employee Q is a participant in the health FSA sponsored by Employer J and is enrolled in Employer J's accident and health plan.

(ii) On March 1, 2009, Q visits a physician's office for medical care as defined in section 213(d). The charge for the physician's services is $150. Under the plan, Q is responsible for 20 percent of the charge for the physician's services (that is, $30). Q has sufficient FSA coverage for the $30 claim.

(iii) Employer J has coordinated with the accident and health plan so that Employer J or its agent automatically receives an EOB from the plan indicating that Q is responsible for payment of 20 percent of the $150 charged by the physician. Because Employer J has received a statement from an independent third-party that Q has incurred a medical expense, the date the expense was incurred, and the amount of the expense, the claim is substantiated without the need for J to submit additional information regarding the expense. Employer J's FSA reimburses Q the $30 medical expense without requiring Q to submit a receipt or a statement from the physician. The substantiation rules in paragraph (b) in this section are satisfied.

(4) ***Advance reimbursement of expenses for qualified benefits prohibited.*** **—**Reimbursing expenses before the expense has been incurred or before the expense is substantiated fails to satisfy the substantiation requirements in §1.105-2, §1.125-1 and this section.

(5) ***Purported loan from employer to employee.*** **—**In determining whether, under all the facts and circumstances, employees are being reimbursed for unsubstantiated claims, special scrutiny will be given to other arrangements such as employer-to-employee loans based on actual or projected employee claims.

(6) ***Debit cards.*** **—**For purposes of this section, a *debit card* is a debit card, credit card, or stored value card. See also paragraphs (c) through (g) of this section for additional rules on payments or reimbursements made through debit cards.

(c) ***Debit cards-overview***

(1) ***Mandatory rules for all debit cards usable to pay or reimburse medical expenses.*** **—**Paragraph (d) of this section sets forth the mandatory procedures for debit cards to substantiate section 213(d) medical expenses. These rules apply to all debit cards used to pay or reimburse medical expenses. Paragraph (e) of this section sets forth additional substantiation rules that may be used for medical expenses incurred at medical care providers and certain stores with the Drug Stores and Pharmacies merchant category code. Paragraph (f) in this section sets forth the requirements for an inventory information approval system which must be used to substantiate medical expenses incurred at merchants or service providers that are not medical care providers or certain stores with the Drug Stores and Pharmacies merchant category code and that may be used for medical expenses incurred at all merchants.

(2) ***Debit cards used for dependent care assistance.*** **—**Paragraph (g) of this section sets forth additional rules for debit cards usable for reimbursing dependent care expenses.

(3) ***Additional guidance.*** **—**The Commissioner may prescribe additional guidance of general applicability, published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), to provide additional rules for debit cards.

(d) ***Mandatory rules for all debit cards usable to pay or reimburse medical expenses.*** **—**A health FSA paying or reimbursing section 213(d) medical expenses through a debit card must satisfy all of the following requirements —

(1) Before any employee participating in a health FSA receives the debit card, the employee agrees in writing that he or she will only use the card to pay for medical expenses (as defined in section 213(d)) of the employee or his or her spouse or dependents, that he or she will not use the debit card for any medical expense that has already been reimbursed, that he or she will not seek reimbursement under any other health plan for any expense paid for with a debit card, and that he or she will acquire and retain sufficient documentation (including invoices and receipts) for any expense paid with the debit card.

(2) The debit card includes a statement providing that the agreements described in paragraph (d)(1) of this section are reaffirmed each time the employee uses the card.

(3) The amount available through the debit card equals the amount elected by the employee for the health FSA for the cafeteria plan year, and is reduced by amounts paid or reimbursed for section 213(d) medical expenses incurred during the plan year.

(4) The debit card is automatically cancelled when the employee ceases to participate in the health FSA.

(5) The employer limits use of the debit card to —

(i) Physicians, dentists, vision care offices, hospitals, other medical care providers (as identified by the merchant category code);

(ii) Stores with the merchant category code for Drugstores and Pharmacies if, on a location by location basis, 90 percent of the store's gross receipts during the prior taxable year consisted of items which qualify as expenses for medical care described in section 213(d); and

(iii) Stores that have implemented the inventory information approval system under paragraph (f).

(6) The employer substantiates claims based on payments to medical care providers and stores described in paragraphs (d)(5)(i) and (ii) of this section in accordance with either paragraph (e) or paragraph (f) of this section.

(7) The employer follows all of the following correction procedures for any improper payments using the debit card —

(i) Until the amount of the improper payment is recovered, the debit card must be de-activated and the employee must request payments or reimbursements of medical expenses from the health FSA through other methods (for example, by submitting receipts or invoices from a merchant or service provider showing the employee incurred a section 213(d) medical expense);

(ii) The employer demands that the employee repay the cafeteria plan an amount equal to the improper payment;

(iii) If, after the demand for repayment of improper payment (as described in paragraph (d)(7)(ii) of this section), the employee fails to repay the amount of the improper charge, the employer withholds the amount of the improper charge from the employee's pay or other compensation, to the full extent allowed by applicable law;

(iv) If any portion of the improper payment remains outstanding after attempts to recover the amount (as described in paragraph (d)(7)(ii) and (iii) of this section), the employer applies a claims substitution or offset to resolve improper payments, such as a reimbursement for a later substantiated expense claim is reduced by the amount of the improper payment. So, for example, if an employee has received an improper payment of $200 and subsequently submits a substantiated claim for $250 incurred during the same coverage period, a reimbursement for $50 is made; and

(v) If, after applying all the procedures described in paragraph (d)(7)(ii) through (iv) of this section, the employee remains indebted to the employer for improper payments, the employer, consistent with its business practice, treats the improper payment as it would any other business indebtedness.

(e) ***Substantiation of expenses incurred at medical care providers and certain other stores with Drug Stores and Pharmacies merchant category code***

(1) ***In general.*** **—**A health FSA paying or reimbursing section 213(d) medical expenses through a debit card is permitted to comply with the substantiation provisions of this paragraph (e), instead of complying with the provisions of paragraph (f), for medical expenses incurred at providers described in paragraph (e)(2) of this section.

(2) ***Medical care providers and certain other stores with Drug Stores and Pharmacies merchant category code.*** **—**Medical expenses may be substantiated using the methods described in paragraph (e)(3) of this section if incurred at physicians, pharmacies, dentists, vision care offices, hospitals, other medical care providers (as identified by the merchant category code) and at stores with the Drug Stores and Pharmacies merchant category code, if, on a store location-by-location basis, 90 percent of the store's gross receipts during the prior taxable year consisted of items which qualify as expenses for medical care described in section 213(d).

(3) ***Claims substantiation for copayment matches, certain recurring medical expenses and real-time substantiation.*** **—**If all of the requirements in this paragraph (e)(3) are satisfied, copayment matches, certain recurring medical expenses and medical expenses substantiated in real-time are substantiated without the need for submission of receipts or further review.

(i) ***Matching copayments-multiples of five or fewer.*** **—**If an employer's accident or health plan covering the employee (or the employee's spouse or dependents) has copayments in specific dollar amounts, and the dollar amount of the transaction at a medical care provider equals an exact multiple of not more than five times the dollar amount of the copayment for the specific service (for example, pharmacy benefit copayment, copayment for a physician's office visit) under the accident or health plan covering the specific employee-cardholder, then the charge is fully substantiated without the need for submission of a receipt or further review.

(A) ***Tiered copayments.*** **—**If a health plan has multiple copayments for the same benefit, (for example, tiered copayments for a pharmacy benefit), exact matches of multiples or combinations of up to five copayments are similarly fully substantiated without the need for submission of a receipt or further review.

(B) ***Copayment match must be exact multiple.*** **—**If the dollar amount of the transaction is not an exact multiple of the copayment (or an exact match of a multiple or combination of different copayments for a benefit in the case of multiple copayments), the transaction must be treated as conditional pending confirmation of the charge, even if the amount is less than five times the copayment.

(C) ***No match for multiple of six or more times copayment.*** **—**If the dollar amount of the transaction at a medical care provider equals a multiple of six or more times the dollar amount of the copayment for the specific service, the transaction must be treated as conditional pending confirmation of the charge by the submission of additional third-party information. See paragraph (d) of this section. In the case of a plan with multiple copayments for the same benefit, if the dollar amount of the transaction exceeds five times the maximum copayment for the benefit, the transaction must also be treated as conditional pending confirmation of the charge by the submission of additional third-party information. In these cases, the employer must require that additional third-party information, such as merchant or service provider receipts, be submitted for review and substantiation, and the third-party information must satisfy the requirements in paragraph (b)(3) of this section.

(D) ***Independent verification of copayment required.*** **—**The copayment schedule required under the accident or health plan must be independently verified by the employer. Statements or other representations by the employee are not sufficient. Self-substantiation or self-certification of an employee's copayment in connection with copayment matching procedures through debit cards or otherwise does not constitute substantiation. If a plan's copayment matching system relies on an employee to provide a copayment amount without verification of the amount, claims have not been substantiated, and all amounts paid from the plan are included in gross income, including amounts paid for medical care whether or not substantiated. See paragraph (b) in this section.

(4) ***Certain recurring medical expenses.*** **—**Automatic payment or reimbursement satisfies the substantiation rules in this paragraph (e) for payment of recurring expenses that match expenses previously approved as to amount, medical care provider and time period (for example, for an employee who refills a prescription drug on a regular basis at the same provider and in the same amount). The payment is substantiated without the need for submission of a receipt or further review.

(5) ***Real-time substantiation.*** **—**If a third party that is independent of the employee and the employee's spouse and dependents (for example, medical care provider, merchant, or pharmacy benefit manager) provides, at the time and point of sale, information to verify to the employer (including electronically by email, the internet, intranet or telephone) that the charge is for a section 213(d) medical expense, the expense is substantiated without the need for further review.

(6) ***Substantiation requirements for all other medical expenses paid or reimbursed through a health FSA debit card.*** **—**All other charges to the debit card (other than substantiated copayments, recurring medical expenses or real-time substantiation, or charges substantiated through the inventory information approval system described in paragraph (f) of this section) must be treated as conditional, pending substantiation of the charge through additional independent third-party information describing the goods or services, the date of the service or sale and the amount of the transaction. All such debit card payments must be substantiated, regardless of the amount of the payment.

(f) ***Inventory information approval system***

(1) ***In general.*** **—**An inventory information approval system that complies with this paragraph (f) may be used to substantiate payments made using a debit card, including payments at merchants and service providers that are not described in paragraph (e)(2) of this section. Debit card transactions using this system are fully substantiated without the need for submission of a receipt by the employee or further review.

(2) ***Operation of inventory information approval system.*** **—**An inventory information approval system must operate in the manner described in this paragraph (f)(2).

(i) When an employee uses the card, the payment card processor's or participating merchant's system collects information about the items purchased using the inventory control information (for example, *stock keeping units* (SKUs)). The system compares the inventory control information for the items purchased against a list of items, the purchase of which qualifies as expenses for medical care under section 213(d) (including nonprescription medications).

(ii) The section 213(d) medical expenses are totaled and the merchant's or payment card processor's system approves the use of the card only for the amount of the section 213(d) medical expenses eligible for coverage under the health FSA (taking into consideration the uniform coverage rule in paragraph (d) of §1.125-5);

(iii) If the transaction is only partially approved, the employee is required to tender additional amounts, resulting in a split-tender transaction. For example, if, after matching inventory information, it is determined that all items purchased are section 213(d) medical expenses, the entire transaction is approved, subject to the coverage limitations of the health FSA;

(iv) If, after matching inventory information, it is determined that only some of the items purchased are section 213(d) medical expenses, the transaction is approved only as to the section 213(d) medical expenses. In this case, the merchant or service-provider must request additional payment from the employee for the items that do not satisfy the definition of medical care under section 213(d);

(v) The merchant or service-provider must also request additional payment from the employee if the employee does not have sufficient health FSA coverage to purchase the section 213(d) medical items;

(vi) Any attempt to use the card at non-participating merchants or service-providers must fail.

(3) ***Employer's responsibility for ensuring inventory information approval system's compliance with §1.105-2, §1.125-1, §1.125-6 and recordkeeping requirements.*** **—**An employer that uses the inventory information approval system must ensure that the inventory information approval system complies with the requirements in §§1.105-2, 1.125-1, and §1.125-6 for substantiating, paying or reimbursing section 213(d) medical expenses and with the recordkeeping requirements in section 6001.

(g) ***Debit cards used to pay or reimburse dependent care assistance***

(1) ***In general.*** **—**An employer may use a debit card to provide benefits under its dependent care assistance program (including a dependent care assistance FSA). However, dependent care expenses may not be reimbursed before the expenses are incurred. See paragraph (a)(4) in this section. Thus, if a dependent care provider requires payment before the dependent care services are provided, the expenses cannot be reimbursed at the time of payment through use of a debit card or otherwise.

(2) ***Reimbursing dependent care assistance through a debit card***. **—**An employer offering a dependent care assistance FSA may adopt the following method to provide reimbursements for dependent care expenses through a debit card —

(i) At the beginning of the plan year or upon enrollment in the dependent care assistance program, the employee pays initial expenses to the dependent care provider and substantiates the initial expenses by submitting to the employer or plan administrator a statement from the dependent care provider substantiating the dates and amounts for the services provided.

(ii) After the employer or plan administrator receives the substantiation (but not before the date the services are provided as indicated by the statement provided by the dependent care provider), the plan makes available through the debit card an amount equal to the lesser of —

(A) The previously incurred and substantiated expense; or

(B) The employee's total salary reduction amount to date.

(iii) The card may be used to pay for subsequently incurred dependent care expenses.

(iv) The amount available through the card may be increased in the amount of any additional dependent care expenses only after the additional expenses have been incurred.

(3) ***Substantiating recurring dependent care expenses***. **—**Card transactions that collect information matching expenses previously substantiated and approved as to dependent care provider and time period may be treated as substantiated without further review if the transaction is for an amount equal to or less than the previously substantiated expenses. Similarly, dependent care expenses previously substantiated and approved through nonelectronic methods may also be treated as substantiated without further review. In both cases, if there is an increase in previously substantiated amounts or a change in the dependent care provider, the employee must submit a statement or receipt from the dependent care provider substantiating the claimed expenses before amounts relating to the increased amounts or new providers may be added to the card.

(4) ***Example***. **—**The following example illustrates the rules in this paragraph (g):

Example. *Recurring dependent care expenses*. (i) Employer K sponsors a dependent care assistance FSA through its cafeteria plan. Salary reduction amounts for participating employees are made on a weekly payroll basis, which are available for dependent care coverage on a weekly basis. As a result, the amount of available dependent care coverage equals the employee's salary reduction amount minus claims previously paid from the plan. Employer K has adopted a payment card program for its dependent care FSA.

(ii) For the plan year ending December 31, 2009, Employee F is a participant in the dependent care FSA and elected $5,000 of dependent care coverage. Employer K reduces F's salary by $96.15 on a weekly basis to pay for coverage under the dependent care FSA.

(iii) At the beginning of the 2009 plan year, F is issued a debit card with a balance of zero. F's childcare provider, ABC Daycare Center, requires a $250 advance payment at the beginning of the week for dependent care services that will be provided during the week. The dependent care services provided for F by ABC qualify for reimbursement under section 129. However, because as of the beginning of the plan year, no services have yet been provided, F cannot be reimbursed for any of the amounts until the end of the first week of the plan year (that is, the week ending January 5, 2009), after the services have been provided.

(iv) F submits a claim for reimbursement that includes a statement from ABC with a description of the services, the amount of the services, and the dates of the services. Employer K increases the balance of F's payment card to $96.15 after the services have been provided (i.e., the lesser of F's salary reduction to date or the incurred dependent care expenses). F uses the card to pay ABC $96.15 on the first day of the next week (January 8, 2009) and pays ABC the remaining balance due for that week ($153.85) by check.

(v) To the extent that this card transaction and each subsequent transaction is with ABC and is for an amount equal to or less than the previously substantiated amount, the charges are fully substantiated without the need for the submission by F of a statement from the provider or further review by the employer. However, the subsequent amount is not made available on the card until the end of the week when the services have been provided. Employer K's dependent care debit card satisfies the substantiation requirements of this paragraph (g).

(h) ***Effective/applicability date***. **—**It is proposed that these regulations apply on and after plan years beginning on or after January 1, 2009. However, the effective dates for the previously issued guidance on debit cards, which is incorporated in this section, remain applicable. [Reg. §1.125-6.]

PROP-REG, 2007FED ¶7323H, §1.125-7., **Cafeteria plan nondiscrimination rules, REG-142695-05, 8/6/2007.**

Cafeteria plan nondiscrimination rules, REG-142695-05, 8/6/2007.

(a) ***Definitions***

(1) ***In general***. **—**The definitions set forth in this paragraph (a) apply for purposes of section 125(b), (c), (e) and (g) and this section.

(2) ***Compensation***. **—**The term *compensation* means compensation as defined in section 415(c)(3).

(3) ***Highly compensated individual***

(i) ***In general***. **—**The term *highly compensated individual* means an individual who is —

(A) An officer;

(B) A five percent shareholder (as defined in paragraph (a)(8) of this section); or

(C) Highly compensated.

(ii) ***Spouse or dependent*. —**A spouse or a dependent of any highly compensated individual described in (a)(3)(i) of this section is a highly compensated individual. Section 125(e).

(4) *Highly compensated participant*. —The term *highly compensated participant* means a highly compensated individual who is eligible to participate in the cafeteria plan.

(5) *Nonhighly compensated individual*. —The term *nonhighly compensated individual* means an individual who is not a highly compensated individual.

(6) *Nonhighly compensated participant*. —The term *nonhighly compensated participant* means a participant who is not a highly compensated participant.

(7) *Officer*. —The term officer means any individual or participant who for the preceding plan year (or the current plan year in the case of the first year of employment) was an officer. Whether an individual is an *officer* is determined based on all the facts and circumstances, including the source of the individual's authority, the term for which he or she is elected or appointed, and the nature and extent of his or her duties. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes individuals performing services in connection with a special and single transaction. An individual who merely has the title of an officer but not the authority of an officer, is not an officer. Similarly, an individual without the title of an officer but who has the authority of an officer is an officer. Sole proprietorships, partnerships, associations, trusts and labor organizations also may have officers. See §§301.7701-1 through -3

(8) *Five percent shareholder*. —A *five percent shareholder* is an individual who in either the preceding plan year or current plan year owns more than five percent of the voting power or value of all classes of stock of the employer, determined without attribution.

(9) *Highly compensated*. —The term *highly compensated* means any individual or participant who for the preceding plan year (or the current plan year in the case of the first year of employment) had compensation from the employer in excess of the compensation amount specified in section 414(q)(1)(B), and, if elected by the employer, was also in the top-paid group of employees (determined by reference to section 414(q)(3)) for such preceding plan year (or for the current plan year in the case of the first year of employment).

(10) *Key employee*. —A *key employee* is a participant who is a key employee within the meaning of section 416(i)(1) at any time during the preceding plan year. A key employee covered by a collective bargaining agreement is a key employee.

(11) *Collectively bargained plan*. —A *collectively bargained plan* is a plan or the portion of a plan maintained under an agreement which is a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that cafeteria plan benefits were the subject of good faith bargaining between such employee representatives and such employer or employers.

(12) *Year of employment*. —For purposes of section 125(g)(3)(B)(i), a *year of employment* is determined by reference to the elapsed time method of crediting service. See §1.410(a)-7.

(13) *Premium-only-plan*. —A premium-only-plan is described in paragraph (a)(5) in §1.125-1.

(14) *Statutory nontaxable benefits*. —*Statutory nontaxable benefits* are qualified benefits that are excluded from gross income (for example, an employer-provided accident and health plan excludible under section 106 or a dependent care assistance program excludible under section 129). Statutory nontaxable benefits also include group-term life insurance on the life of an employee includible in the employee's gross income solely because the coverage exceeds the limit in section 79(a).

(15) *Total benefits*. —*Total benefits* are qualified benefits and permitted taxable benefits.

(b) *Nondiscrimination as to eligibility*

(1) *In general*. —A cafeteria plan must not discriminate in favor of highly compensated individuals as to eligibility to participate for that plan year. A cafeteria plan does not discriminate in favor of highly compensated individuals if the plan benefits a group of employees who qualify under a reasonable classification established by the employer, as defined in §1.410(b)-4(b), and the group of employees included in the classification satisfies the safe harbor percentage test or the unsafe harbor percentage component of the facts and circumstances test in §1.410(b)-4(c). (In applying the §1.410(b)-4 test, substitute highly compensated individual for highly compensated employee and substitute nonhighly compensated individual for nonhighly compensated employee).

(2) *Deadline for participation in cafeteria plan*. —Any employee who has completed three years of employment (and who satisfies any conditions for participation in the cafeteria plan that are not related to completion of a requisite length of employment) must be permitted to elect to participate in the cafeteria plan no later than the first day of the first plan year beginning after the date the employee completed three years of employment (unless the employee separates from service before the first day of that plan year).

(3) *The safe harbor percentage test*

(i) *In general*. —For purposes of the safe harbor percentage test and the unsafe harbor percentage component of the facts and circumstances test, if the cafeteria plan provides that only employees who have completed three years of employment are permitted to participate in the plan, employees who have not completed three years of employment may be excluded from consideration. However, if the cafeteria plan provides that employees are allowed to participate before completing three years of employment, all employees with less than three years of employment must be included in applying the safe harbor percentage test and the unsafe harbor percentage component of the facts and circumstances test. See paragraph (g) of this section for a permissive disaggregation rule.

(ii) *Employees excluded from consideration*. —In addition, for purposes of the safe harbor percentage test and the unsafe harbor percentage component of the facts and circumstances test, the following employees are excluded from consideration —

(A) Employees (except key employees) covered by a collectively bargained plan as defined in paragraph (a)(11) of this section;

(B) Employees who are nonresident aliens and receive no earned income (within the meaning of section 911(d)(2)) from the employer which constitutes income from sources within the United States (within the meaning of section 861(a)(3)); and

(C) Employees participating in the cafeteria plan under a COBRA continuation provision.

(iv) ***Examples. —***The following examples illustrate the rules in paragraph (b) of this section:

Example 1. Same qualified benefit for same salary reduction amount. Employer A has one employer-provided accident and health insurance plan. The cost to participants electing the accident and health plan is $10,000 per year for single coverage. All employees have the same opportunity to salary reduce $10,000 for accident and health plan. The cafeteria plan satisfies the eligibility test.

Example 2. Same qualified benefit for unequal salary reduction amounts. Same facts as *Example 1* except the cafeteria plan offers nonhighly compensated employees the election to salary reduce $10,000 to pay premiums for single coverage. The cafeteria plan provides an $8,000 employer flex-credit to highly compensated employees to pay a portion of the premium, and provides an election to them to salary reduce $2,000 to pay the balance of the premium. The cafeteria plan fails the eligibility test.

Example 3. Accident and health plans of unequal value. Employer B's cafeteria plan offers two employer-provided accident and health insurance plans: Plan X, available only to highly compensated participants, is a low-deductible plan. Plan Y, available only to nonhighly compensated participants, is a high deductible plan (as defined in section 223(c)(2)). The annual premium for single coverage under Plan X is $15,000 per year, and $8,000 per year for Plan Y. Employer B's cafeteria plan provides that highly compensated participants may elect salary reduction of $15,000 for coverage under Plan X, and that nonhighly compensated participants may elect salary reduction of $8,000 for coverage under Plan Y. The cafeteria plan fails the eligibility test.

Example 4. Accident and health plans of unequal value for unequal salary reduction amounts. Same facts as *Example 3*, except that the amount of salary reduction for highly compensated participants to elect Plan X is $8,000. The cafeteria plan fails the eligibility test.

(c) ***Nondiscrimination as to contributions and benefits***

(1) ***In general. —***A cafeteria plan must not discriminate in favor of highly compensated participants as to contributions and benefits for a plan year.

(2) ***Benefit availability and benefit election. —***A cafeteria plan does not discriminate with respect to contributions and benefits if either qualified benefits and total benefits, or employer contributions allocable to statutory nontaxable benefits and employer contributions allocable to total benefits, do not discriminate in favor of highly compensated participants. A cafeteria plan must satisfy this paragraph (c) with respect to both benefit availability and benefit utilization. Thus, a plan must give each similarly situated participant a uniform opportunity to elect qualified benefits, and the actual election of qualified benefits through the plan must not be disproportionate by highly compensated participants (while other participants elect permitted taxable benefits). Qualified benefits are disproportionately elected by highly compensated participants if the aggregate qualified benefits elected by highly compensated participants, measured as a percentage of the aggregate compensation of highly compensated participants, exceed the aggregate qualified benefits elected by nonhighly compensated participants measured as a percentage of the aggregate compensation of nonhighly compensated participants. A plan must also give each similarly situated participant a uniform election with respect to employer contributions, and the actual election with respect to employer contributions for qualified benefits through the plan must not be disproportionate by highly compensated participants (while other participants elect to receive employer contributions as permitted taxable benefits). Employer contributions are disproportionately utilized by highly compensated participants if the aggregate contributions utilized by highly compensated participants, measured as a percentage of the aggregate compensation of highly compensated participants, exceed the aggregate contributions utilized by nonhighly compensated participants measured as a percentage of the aggregate compensation of nonhighly compensated participants.

(3) ***Example. —***The following example illustrates the rules in paragraph (c) of this section:

Example. Contributions and benefits test. Employer C's cafeteria plan satisfies the eligibility test in paragraph (b) of this section. Highly compensated participants in the cafeteria plan elect aggregate qualified benefits equaling 5 percent of aggregate compensation; nonhighly compensated participants elect aggregate qualified benefits equaling 10 percent of aggregate compensation. Employer C's cafeteria plan passes the contribution and benefits test.

(d) ***Key employees***

(1) ***In general. —***If for any plan year, the statutory nontaxable benefits provided to key employees exceed 25 percent of the aggregate of statutory nontaxable benefits provided for all employees through the cafeteria plan, each key employee includes in gross income an amount equaling the maximum taxable benefits that he or she could have elected for the plan year. However, see safe harbor for premium-only-plans in paragraph (f) of this section.

(2) ***Example. —***The following example illustrates the rules in paragraph (d) of this section:

Example. (i) *Key employee concentration test*. Employer D's cafeteria plan offers all employees an election between taxable benefits and qualified benefits. The cafeteria plan satisfies the eligibility test in paragraph (b) of this section. Employer D has two key employees and four nonhighly compensated employees. The key employees each elect $2,000 of qualified benefits. Each nonhighly compensated employee also elects $2,000 of qualified benefits. The qualified benefits are statutory nontaxable benefits.

(ii) Key employees receive $4,000 of statutory nontaxable benefits and nonhighly compensated employees receive $8,000 of statutory nontaxable benefits, for a total of $12,000. Key employees receive 33 percent of statutory nontaxable benefits (4,000/12,000). Because the cafeteria plan provides more than 25 percent of the aggregate of statutory nontaxable benefits to key employees, the plan fails the key employee concentration test.

(e) ***Safe harbor for cafeteria plans providing health benefits***

(1) ***In general. —***A cafeteria plan that provides health benefits is not treated as discriminatory as to benefits and contributions if:

(i) Contributions under the plan on behalf of each participant include an amount which equals 100 percent of the cost of the health benefit coverage under the plan of the majority of the highly compensated participants similarly situated, or equals or exceeds 75 percent of the cost of the health benefit coverage of the participant (similarly situated) having the highest cost health benefit coverage under the plan, and

(ii) Contributions or benefits under the plan in excess of those described in paragraph (e)(1)(i) of this section bear a uniform relationship to compensation.

(2) ***Similarly situated.*** **—**In determining which participants are similarly situated, reasonable differences in plan benefits may be taken into account (for example, variations in plan benefits offered to employees working in different geographical locations or to employees with family coverage versus employee-only coverage).

(3) *Health benefits*. Health benefits for purposes of this rule are limited to major medical coverage and exclude dental coverage and health FSAs.

(4) ***Example.*** **—**The following example illustrates the rules in paragraph (e) of this section:

Example. (i) All 10 of Employer E's employees are eligible to elect between permitted taxable benefits and salary reduction of $8,000 per plan year for self-only coverage in the major medical health plan provided by Employer E. All 10 employees elect $8,000 salary reduction for the major medical plan.

(ii) The cafeteria plan satisfies the section 125(g)(2) safe harbor for cafeteria plans providing health benefits.

(f) ***Safe harbor test for premium-only-plans***

(1) ***In general.*** **—**A premium-only-plan (as defined in paragraph (a)(13) of this section) is deemed to satisfy the nondiscrimination rules in section 125(c) and this section for a plan year if, for that plan year, the plan satisfies the safe harbor percentage test for eligibility in paragraph (b)(3) of this section.

(2) ***Example.*** **—**The following example illustrates the rules in paragraph (f) of this section:

Example. *Premium-only-plan*. (i) Employer F's cafeteria plan is a premium-only-plan (as defined in paragraph (a)(13) of this section). The written cafeteria plan offers one employer-provided accident and health plan and offers all employees the election to salary reduce same amount or same percentage of the premium for self-only or family coverage. All key employees and all highly compensated employees elect salary reduction for the accident and health plan, but only 20 percent of nonhighly compensated employees elect the accident and health plan.

(ii) The premium-only-plan satisfies the nondiscrimination rules in section 125(b) and (c) and this section.

(g) ***Permissive disaggregation for nondiscrimination testing***

(1) ***General rule.*** **—**If a cafeteria plan benefits employees who have not completed three years of employment, the cafeteria plan is permitted to test for nondiscrimination under this section as if the plan were two separate plans —

(i) One plan benefiting the employees who completed one day of employment but less than three years of employment; and

(ii) Another plan benefiting the employees who have completed three years of employment.

(2) ***Disaggregated plans tested separately for eligibility test and contributions and benefits test.*** **—**If a cafeteria plan is disaggregated into two separate plans for purposes of nondiscrimination testing, the two separate plans must be tested separately for both the nondiscrimination as to eligibility test in paragraph (b) of this section and the nondiscrimination as to contributions and benefits test in paragraph (c) of this section.

(h) ***Optional aggregation of plans for nondiscrimination testing.*** **—**An employer who sponsors more than one cafeteria plan is permitted to aggregate two or more of the cafeteria plans for purposes of nondiscrimination testing. If two or more cafeteria plans are aggregated into a combined plan for this purpose, the combined plan must satisfy the nondiscrimination as to eligibility test in paragraph (b) of this section and the nondiscrimination as to contributions and benefits test in paragraph (c) of this section, as though the combined plan were a single plan. Thus, for example, in order to satisfy the benefit availability and benefit election requirements in paragraph (c)(2) of this section, the combined plan must give each similarly situated participant a uniform opportunity to elect qualified benefits and the actual election of qualified benefits by highly compensated participants must not be disproportionate. However, if a principal purpose of the aggregation is to manipulate the nondiscrimination testing requirements or to otherwise discriminate in favor of highly compensated individuals or participants, the plans will not be permitted to be aggregated for nondiscrimination testing.

(i) ***Employees of certain controlled groups.*** **—**All employees who are treated as employed by a single employer under section 414(b), (c), (m), or (o) are treated as employed by a single employer for purposes of section 125. Section 125(g)(4); section 414(t).

(j) ***Time to perform nondiscrimination testing***

(1) ***In general.*** **—**Nondiscrimination testing must be performed as of the last day of the plan year, taking into account all non-excludable employees (or former employees) who were employees on any day during the plan year.

(2) The following example illustrates the rules in paragraph (j) of this section:

Example. *When to perform discrimination testing*. (i) Employer H employs three employees and maintains a calendar year cafeteria plan. During the 2009 plan year, Employee J was an employee the entire calendar year, Employee K was an employee from May 1, through August 31, 2009, and Employee L worked from January 1, 2009 to April 15, 2009, when he retired.

(ii) Nondiscrimination testing for the 2009 plan year must be performed on December 31, 2009, taking into account employees J, K, and L's compensation in the preceding year.

(k) ***Discrimination in actual operation prohibited*****. —**In addition to not discriminating as to either benefit availability or benefit utilization, a cafeteria plan must not discriminate in favor of highly compensated participants in actual operation. For example, a plan may be discriminatory in actual operation if the duration of the plan (or of a particular nontaxable benefit offered through the plan) is for a period during which only highly compensated participants utilize the plan (or the benefit). See also the key employee concentration test in section 125(b)(2).

(l) ***Anti-abuse rule***

(1) ***Interpretation*****. —**The provisions of this section must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated individuals, highly compensated participants and key employees.

(2) ***Change in plan testing procedures*****. —**A plan will not be treated as satisfying the requirements of this section if there are repeated changes to plan testing procedures or plan provisions that have the effect of manipulating the nondiscrimination testing requirements of this section, if a principal purpose of the changes was to achieve this result.

(m) ***Tax treatment of benefits in a cafeteria plan***

(1) ***Nondiscriminatory cafeteria plan*****. —**A participant in a nondiscriminatory cafeteria plan (including a highly compensated participant or key employee) who elects qualified benefits is not treated as having received taxable benefits offered through the plan, and thus the qualified benefits elected by the employee are not includible in the employee's gross income merely because of the availability of taxable benefits. But see paragraph (j) in §1.125-1 on nondiscrimination rules for sections 79(d), 105(h), 129(d), and 137(c)(2), and limitations on exclusion.

(2) ***Discriminatory cafeteria plan*****. —**A highly compensated participant or key employee participating in a discriminatory cafeteria plan must include in gross income (in the participant's taxable year within which ends the plan year with respect to which an election was or could have been made) the value of the taxable benefit with the greatest value that the employee could have elected to receive, even if the employee elects to receive only the nontaxable benefits offered.

(n) ***Employer contributions to employees' Health Savings Accounts*****. —**If an employer contributes to employees' Health Savings Accounts (HSAs) through a cafeteria plan (as defined in §54.4980G-5 of this chapter) those contributions are subject to the to the nondiscrimination rules in section 125 and this section and are not subject to the comparability rules in section 4980G. See §§ 54.4980G-0 through 54.4980G-5 of this chapter.

(o) ***Effective/applicability date*****. —**It is proposed that these regulations apply on and after plan years beginning on or after January 1, 2009. [Reg. §1.125-7.]