CHAPTER 15

Small Business and The Cafeteria Plan

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SYNOPSIS

§ 1.01 SMALL BUSINESS AND THE CAFETERIA PLAN

The health care situation in our country presents problems for employees of small businesses. Many small businesses simply cannot provide any health insurance coverage for their employees; others are only able to pay a portion of the premiums. As in past years, health insurance premiums continue to rise for small business; increases in premiums for small businesses this year are often in the 15% to 25% range. Many small businesses survive on the margin and are careful to provide only those employee benefits that the company can afford. Because of the increasingly high cost of benefits, small businesses are often reluctant to provide life insurance, disability insurance and dependent care assistance to their employees. As the cost of benefits increases, small business becomes less able to afford these benefits for its employees. Yet providing these benefits through the private sector and the work place is a critical social concern for this country, particularly as the population ages.

Unless assistance is forthcoming, small businesses may be unable to provide these significant benefits for their employees. An employee benefit delivery system which could alleviate some of the additional costs in this area and significantly increase the availability of health insurance, disability insurance and dependent care assistance is the cafeteria plan.[1] As efforts continue to increase employee benefits for small business employees, the cafeteria plan should not be overlooked.

[1] Cafeteria plans are defined in Section 125 of the Internal Revenue Code of 1986, as amended, (hereinafter "Code" or "I.R.C.") and are therefore sometimes referred to as Section 125 plans.

§1.02 TYPES OF CAFETERIA PLANS

[1] Three Types of Cafeteria Plans

Cafeteria plans are one of the more popular employee benefits. They generally operate in one of three ways -- employee pay-all, employer "dollars" only, or a combination of the two. Employee pay-all plans allow employees to select among a variety of benefits and pay for these benefits by reducing their salaries. (This is similar to the salary deferral election in a 401(k) plan.) Employer funded plans provide each eligible employee a certain amount of employer dollars, sometimes referred to as "cafeteria plan dollars" which the employee allocates among a variety of benefits. Some companies require that these employer "dollars" be allocated first to health insurance benefits, with the employee allocating any remaining cafeteria dollars to other benefits as the employee chooses. The employee may cash out, generally at a discounted rate, any dollars which the employee does not use to acquire cafeteria plan benefits.[2] The third method involves both employer dollars and employee salary reduction dollars. Under this plan design, the employees first allocate employer provided "cafeteria plan dollars" among the available benefits. The employees are also able to defer a portion of their salaries, using these salary deferral dollars to select additional benefits or purchase additional protection.

[2] Tax Benefits of Cafeteria Plans

Regardless of the type of cafeteria plan offered, each plan allows eligible employees to choose between receiving particular qualified benefits and cash. Prior to the beginning of a plan year, eligible

[2] A plan which uses only employer contributed dollars, and does not include either an option for employee pre-tax, salary deferral dollars or a cash out option (a so-called American Can Plan) is not a true cafeteria plan and does not have to qualify under I.R.C. §125. Prop. Treas. Reg. §1.125-1, Q&A 2.

employees must elect between receiving their full salary, on the one hand, and deferring a portion of their salary and/or applying their cafeteria plan dollars, on the other hand. The employee deferred salary and employer cafeteria plan dollars will then be used to pay for the selected benefits. The election, once made, is generally irrevocable for the plan year, absent certain major changes in circumstances.[3] If an employee chooses salary reduction, the employee does not pay income taxes on the salary reduction amount, the employer does not pay FICA (Social Security and Medicare) and FUTA taxes on the salary reduction amount,[4] and the withheld salary is used to pay for the desired benefit. Thus, the state and federal governments incur reduced revenues (lower income, FICA and FUTA taxes), but important social welfare benefits are provided through the private sector.

With cafeteria plans, employees can pay for a wide variety of benefits, such as health insurance, child care, care for elderly dependents, or out-of-pocket medical costs, with pre-tax dollars, selecting from among the benefits offered only those benefits which they want. Employers achieve tax savings as well since the employee salary reduction dollars and employer contributions are not taken into account when computing FICA and FUTA taxes.[5] While employers determine the benefits to be offered under the cafeteria plan, employees have the flexibility to select only the particular benefits that are of greatest value to them. Thus, flexibility in the selection of benefits and affordability through the use of pre-tax dollars are the hallmarks of the cafeteria plan.

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[3] See §1.04, *infra*, for a further discussion of the generally irrevocable nature of the election and the circumstances under which the employee may prospectively modify an election.

[4] In some jurisdictions, employers will also save on unemployment insurance and worker's compensation taxes if these are tied to the employee's taxable wages.

[5] Prop. Treas. Reg. §1.125-1, Q&A 6.

[3] Premium Conversion Plans

Perhaps the most simple cafeteria plan is the "premium only" plan or "premium conversion" plan. This plan may best be viewed as a simple salary reduction plan. In a salary reduction plan, prior to the beginning of the plan year, the employee authorizes a salary reduction which can then be used to acquire specified benefits. In a premium conversion plan, the only employee benefit offered is health insurance. Therefore, the salary reduction amount is used by the employer to pay the employee's share of health insurance premiums.

The premium conversion plan may be used as part of a variety of different premium payment arrangements. Employees may be required to pay the entire health insurance premium. Under this approach the employer's contribution is simply to create and administer a cafeteria plan so that employees may convert their premium payments from after-tax to pre-tax dollars. Under other arrangements the employer may provide some portion of the premium, regardless of the coverage elected, with participating employees paying the balance. In this instance the employer contributes funds only on behalf of the participating employees who are paying for the remaining portion of the premium. Alternatively, an employer may specify a certain level of contribution for employee-only coverage and a lower contribution (perhaps none) for that portion of the health insurance premium relating to coverage of the employee's family. Regardless of the level of the employer's contribution, however, if the insurance is an eligible benefit and the cafeteria plan is properly structured and administered, the employee's portion of the premiumwill be paid with pre-tax dollars.

[4] Salary Reduction Plans

A salary reduction plan is a cafeteria plan in which eligible employees have a choice to receive their full salary in cash or to have their salary reduced, with the salary reduction used by the employee to pay for one or more employee benefits offered under the plan. The employee's election, once made for a plan year, is (with certain exceptions) irrevocable, and the salary reduction amount is taken ratably from each paycheck throughout the year. Receiving an unreduced salary is essentially the "cash option" in a salary reduction plan. If the choice to defer salary is offered under a qualified cafeteria plan, the employee is not deemed to be in constructive receipt of the salary reduction amount and the salary reduction amounts do not constitute W-2 wages and are not subject to income, FICA or FUTA taxes.[6] In essence, the employee has the opportunity to convert the cost of various benefits from an after-tax cost to a pre-tax cost.

[5] Flexible Benefits Plans

Although a cafeteria plan may be funded solely using voluntary employee deferrals, employer contributions may also be used. Plans involving employer contributions are called flexible benefits plans.[7] Those that also include either employee salary deferrals or cash-outs must qualify under I.R.C. §125 since they involve a choice between a taxable benefit (compensation income) and a non-taxable benefit. Under these plans employees are permitted to purchase additional non-taxable benefits using salary reduction dollars and may be permitted to receive a certain amount of cash if they do not want to apply the full amount of employer contributed dollars towards acquiring non-taxable benefits. The cash out feature, coupled with employee salary deferrals, affords the employee significant flexibility. If employer cafeteria

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[6] Prop. Treas. Reg. §1.125-1, Q&A 9.

[7] As discussed at note 2, *supra*, plans involving only employer contributions without a cash out option are not cafeteria plans and therefore need not qualify under I.R.C. § 125.

plan dollars exceedthe amount the employee can use effectively, the employee can cash out the excess. On the other hand, if the employer cafeteria plan dollars are less than the amount the employee prefers to spend on the available benefits, the employee can increase the available dollars through salary reductions.

§1.03 BENEFITS OFFERED

I.R.C. §125(f) defines the benefits that may be offered under a cafeteria plan as "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)." Thus, medical savings accounts (I.R.C. §106(b)), qualified scholarships (I.R.C. §117), educational assistance programs (I.R.C. §127) and fringe benefit programs (I.R.C. §132) are expressly excluded. **[1] Wide Variety of Benefits May Be Offered In Cafeteria Plans**

The provisions excluding certain items from income (and thus, allowing those items to be included in a cafeteria plan) are found in I.R.C. §§101-138. The benefits that may be offered through a cafeteria plan include:

(i) Accident or health plan coverage (I.R.C. §106), including traditional group health insurance, insurance through health maintenance organizations ("HMOs"), insurance through preferred provider organizations ("PPOs"), self-insured medical reimbursement plans, accidental death and dismemberment policies, hospital indemnity policies, cancer insurance policies, short and long term disability policies, Medicare supplemental coverage and Medicare Part B premiums, employee contributions under a workers' compensation act, prepaid vision, prepaid prescription drugs and prepaid discount plans

(ii) Group term life insurance[8]

(iii) Adoption assistance (I.R.C. §137)

(iv) 401(k) cash or deferred arrangement (I.R.C. §25(d)(2)(B)) (although cafeteria plans generally may not offer benefits that defer compensation)

(v) Certain contributions for post-retirement life insurance by covered employees of educational organizations (I.R.C. §125(d)(2)(C)) and

(vi) Paid vacation days and paid time off (rarely included because of administrative problems).[9]

Of the benefits expressly excluded from a cafeteria plan, perhaps the most troubling, from the viewpoint of public policy, is long term care insurance[10].

[2] Two Common Benefits Offered Under Cafeteria Plans: Health Flexible Spending Accounts and Dependent Care Assistance Plans

Two benefits often provided under a cafeteria plan are the health flexible spending arrangement (health FSA)[11] and the dependent care assistance plan (DCAP).[12] The health FSA can be used to

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[8] Group term life insurance for an employee is a qualified benefit. I.R.C. §125(f). Thus, an employee may purchase group term life insurance up to the $50,000 limit through a cafeteria plan with pre-tax dollars. Additional insurance may be offered as a qualified benefit under a cafeteria plan but there is no tax advantage in purchasing this excess amount under the plan. The premium for the first $50,000 of coverage is excluded from gross income for federal income tax purposes and is not treated as wages for FICA purposes. I.R.C. §§79(a) and 3121(a)(2)(C). However, the cost of the insurance coverage in excess of $50,000 (less any amount paid by the employee with after-tax dollars) is included in gross income for federal income tax purposes and is included in wages for FICA purposes. I.R.C. §§79(a), 3401(a)(14) and 3121(a)(2)(C).

[9] Because paid vacation days and paid time off are not often included as an available benefit under a cafeteria plan, these particular benefits are not discussed further in this chapter.

[10] I.R.C. §125(f).

[11] Health FSAs are governed by a variety of statutes and regulations, including I.R.C. §§105(h)(6) and 106(c)(2), Treas. Regs. §§1.105-11and 1.125-2, Q&A 7 and a variety of other laws.

[12] DCAPs are governed by I.R.C. §129.

reimburse the employee for medical or dental expenses incurred during the plan year that were not reimbursed through insurance or other arrangements. These could include, for example, insurance co-pays, deductibles, glasses and orthodontia. DCAPs enable employees to use a certain amount of pre-tax dollars to pay for household services or care of a dependent[13] if these are "employment related expenses" that are necessary to enable the employee to seek or maintain work.[14]

§1.04 CERTAIN BENEFITS INVOLVE RISK AND COMPLICATIONS

Each of the benefits that may be offered under a cafeteria plan umbrella is subject to its own set of requirements in order to qualify for preferred tax treatment. As will be discussed further in this section, the rules applicable to two of the more common benefits, health FSAs and DCAPs, require that employee dollars be placed at risk. With respect to health FSAs, but not DCAPs, employer dollars also must be placed at risk. In addition, each of the individual benefits is subject to its own set of discrimination testing.

When individual benefits are packaged under the cafeteria plan umbrella, *additional* requirements are imposed. Simply because benefits are offered through a cafeteria plan, an entire additional layer of discrimination tests become applicable. Other rules significantly restrict the circumstances under which an employee may change an election regarding his or her level of participation during a plan year. This additional layer of regulations adds to the complexity and cost of administering cafeteria plans and tends to discourage small business, in particular, from offering employees benefits through a cafeteria plan. Each

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[13] For example, a DCAP may be used to provide child care for dependent children under age 13 or care for an adult dependent who is physically or mentally incapable of caring for himself.

[14] I.R.C. §§129(e)(1) and 21(b)(2).

of these issues will be discussed in the next few sections of this chapter.

[1] Health FSAs

A self-insured medical reimbursement plan is an employer plan to reimburse employees for expenses of medical care not reimbursed under a health and accident insurance policy. The key characteristic of these plans is that they are self-insured: seldom is reimbursement provided by a company regulated as an insurance company (e.g., an insurance company or a pre-paid health care plan). Congress enacted I.R.C. §105, which regulates self-insured medical reimbursement plans, in order to deal with plans that essentially functioned as major medical insurance. Health FSAs, which cover only those expenditures not reimbursed by the employee's major medical insurance plan, were not common at that time. Nonetheless, they fall within the definition of a self-insured medical reimbursement plan included in I.R.C. §105.[15] In essence, health FSAs have been swept up into a system of regulation never intended to apply to them. As a result, some of the rules applicable to a traditional self-insured medical reimbursement plan, when applied to a health FSA, simply do not make sense.[16]

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[15] See, McCormick and Hickman, Cafeteria Plans, Employee Benefits Institute of America, LLC, Vol. I, Chapter XIX, p. 503 (2002).

[16] Although this chapter emphasizes the additional requirements imposed on health FSAs by virtue of their qualifying as self-insured medical reimbursement plans under I.R.C. §105, health FSAs can get swept up in regulations imposed by other laws as well. Health FSAs are treated as group health plans for purposes of the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), Pub. L. No. 99-272, U.S.C.A. §1191b(d)(1) (West 1999), the Health Insurance Portability and Accountability Act ("HIPAA"), Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), Pub. L. No. 104-191, 29 U.S.C.A. § 1181(f) (West 1999) and the Medicare Secondary Payer ("MSP") rules. I.R.C. §5000(b)(1) and 42 U..S.C. §1395y(b)(1)(v). Most health FSAs are group health plans within the meaning of COBRA, HIPAA and the MSP rules unless they qualify for an exemption under the relevant statute. *See*, e.g., 62 Fed Reg. 67687 (Dec. 29, 1997). Health FSAs generally are subject to COBRA unless maintained by a small employer, church or the federal government. Many health FSAs qualify for an exemption under HIPAA. Most health FSAs, other than government plans and church plans, are also subject to additional rules and regulations under the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406 (codified as amended in Titles 5, 18, 26, 29, 42 of U.S.C.) ("ERISA") as employee welfare benefit plans. The layers of requirements applicable to health FSAs are burdensome, particularly to a small business.

[a] *Health FSAs Must Exhibit Risk-Shifting and Risk-Distribution Characteristics*

One of these rules is that health FSAs must qualify as accident or health plans.[17] Essentially, the I.R.S. regulations require that any self-insured medical reimbursement plan, including a health FSA, "exhibit the risk-shifting and risk-distribution characteristics of insurance."[18] While this requirement may make sense when applied to a self-insurance program that essentially substitutes for full-blown major medical health and accident insurance, applying these risk-shifting principles to a plan that uses the employee's own salary to fill in the gaps under a primary medical insurance plan seems misplaced.

[b] *Employee Funds Placed At Risk: "Use-It-Or-Lose-It" Feature*

The risk-shifting and risk-distribution features result in both employers and employees having to place dollars at risk. Employee risk comes in the form of the "use it or lose it" rule.[19] Once the employee elects an amount of salary reduction for the health FSA,[20] a proportionate amount is withdrawn from each paycheck. If the employee does not file health FSA claims equal to the full salary reduction amountin a

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[17] Prop. Treas. Reg. §1.125-2, Q&A 7.

[18] Id.

[19] The "use-it-or-lose-it" feature is derived from Prop. Treas. Reg. § 1.125-2, Q&A 7. When the health FSA is offered through a cafeteria plan, Prop. Treas. Reg. §1.125-2, Q&A 5 requires that benefits included in the plan not defer the receipt of compensation. Thus, the Proposed Regulations require that any amounts set aside in one plan year must be used to acquire benefits in that plan year, and the employee may not carry over these funds to a subsequent plan year to acquire benefits in that later year.

[20] The statutory limit for DCAPs is $5,000 per year (or $2,500 per year in the case of a married person filing separately). I.R.C. §129(a)(1). This limit is reduced, however, to the lesser of the employee's (or spouse's) earned income. I.R.C. §129(a)(2) and (b). Health FSAs, in contrast, are not subject to a flat statutory maximum but are limited through a different requirement: the maximum amount of reimbursement which is reasonably available to a participant must be less than 500% of the value of the coverage. I.R.C. §106(c)(2).

plan year, he or she forfeits the balance.[21] The forfeited amounts become part of the general assets of the employer. While the employer may choose to use the forfeited amounts to increase the total assets available to all employees the following year under the cafeteria plan, this is not required. Moreover, the employer is not permitted to distribute the unused amount to the specific employee who failed to use his or her entire salary reduction account.[22] In essence, the health FSA includes a use-it-or-lose-it feature which forces employees to be conservative in their estimate of the appropriate level of salary reduction and discourages employees from taking maximum advantage of the benefit.[23]

[c] *Employer Funds Placed At Risk: The Uniform Coverage Requirement*

Employer dollars are also at risk in a health FSA. The health FSA must provide "uniform coverage" throughout the plan year so that the maximum reimbursement amount is available at all times during the plan year (reduced by prior reimbursements).[24] Once the plan year begins, the employee may file claims up to the employee's full salary reduction amount, even if these claims exceed the amount already withdrawn from his or her salary during the plan year and contributed to the employee's health FSA. For example, assume an employee arranges to have $50 contributed to his or her health FSA every two weeks.

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[21] Prop. Treas. Reg. §1.125-2, Q&A 7 requires that reimbursements from the plan be used only to reimburse an employee for medical expenses "previously incurred during the period of coverage." In other words, funds may not be used to reimburse an employee for expenses incurred during a prior plan year. Also, the health FSA may not repay the employee any unused portion of the amount set aside. Moreover, since the amount set aside must be used solely to reimburse the employee for medical expenses, the employee may not be entitled to the set aside amounts "in the form of cash or any other taxable or nontaxable benefit (including health coverage for an additional period) without regard to whether or not the employee incurs medical expenses during the period of coverage." *Id.* In other words, the Proposed Regulations prohibit reimbursing or carrying forward unused set aside amounts to future plan years.

[22] Prop. Treas. Reg. §1.125-2, Q&A 7.

[23] A similar use-it-or-lose-it feature applies to DCAPs as well. *See* §1.03[3], *infra*.

[24] Prop. Treas. Reg. §1.125-2, Q&A 7 (b)(2).

This would amount to salary reductions of $1,300 throughout the plan year. The employee must be able to claim the full $1,300 (less any previously reimbursed amounts) at any time during the plan year. Thus, if the employee incurs medical expenses in the first month of the plan year and submits $500 of valid medical reimbursement claims, the employer must reimburse the full $500, even though the employee's salary reductions at the time of the claim only amount to $100. Should the employee terminate service three weeks later, the employer will have paid out more than has been withdrawn from the employee's salary for his or her health FSA. This "uniform coverage" rule discourages employers from offering generous caps on health FSAs since the full amount offered is at risk even before the employee fully funds his or her account through salary reductions.

[d] *Reimbursement Only for Costs Incurred*

Employees may be reimbursed only for expenses actually incurred.[25] This can create difficulties when a particular service is provided over an extended period of time but the employee must pay for most or all of the service at the beginning of treatment. For example, an employee may contract for orthodontia, fertility treatments or prenatal care and pay all or a substantial portion of the total medical fee at the beginning of treatment. Under these circumstances, the terms of the particular cafeteria plan may not permit reimbursement of the entire amount when initially paid by the employee since much of the medical treatment will not be provided until after the initial payment.[26] This can leave the employee with the double expense

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[25] Prop. Treas. Reg. §1.125-1, Q&A 17. Expenses are treated as having been incurred when the participant is provided with the medical care that gives rise to the medical expenses, and not when the participant is formally billed, charged for, or pays for the medical care. Id. For a similar requirement with respect to DCAPs, see Prop. Treas. Reg. §1.125-1, Q&A 18.

[26] In an IRS Information Letter (February 19, 1997), the IRS indicated that the employer may have discretion to reimburse expenses as they are paid in connection with a payment plan even if the charges are front-loaded. The Information Letter, however, is not binding on the IRS. Accordingly, employers often are advised to correlating

of (i) having to pay for the medical care out of pocket before it can be reimbursed and (ii) incurring salary reductions which cannot be claimed even though the medical expense has been incurred.[27] Many non-highly compensated employees[28] ("NHCEs") cannot afford to have wages deducted significantly in advance of reimbursement and therefore choose not to participate in the DCAP or health FSA.

[2] Dependent Care Assistance Plans

Dependent care assistance programs that are designed as flexible spending arrangements[29] are subject to the same "use-it-or-lose-it" requirements[30] of health FSAs but are not subject to the special uniform coverage requirements.[31] Thus, as with the health FSA, any portion of the DCAP account for

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reimbursements closely with the actual provision of medical care.

[27] A similar problem may arise in the context of dependent care. A child care program, for example, may require a substantial application or agency fee before the child care provider arrives. The cafeteria plan may not reimburse this amount when paid, however, since no child care services have yet been rendered. In these situations, there can be a lag between the time when the employee incurs dependent care fees and incurs salary reductions, on the one hand, and the time when these expenses can be recovered. This problem is particularly acute for the lower income taxpayer who cannot afford to have his or her salary reduced when reimbursement is delayed.

[28] The term "highly compensated employee" is defined and discussed in detail at §1.05[1][a], *infra*.

[29] Prop. Treas. Regs. §1.125-2, Q&A 7(c) defines a flexible spending arrangement as a benefit program that provides employees with coverage under which specified incurred expenses may be reimbursed and under which the maximum amount of reimbursement that is reasonably available to a participate for a period of coverage is not substantially in excess of the total premium (including employer and employee contributed amounts) for the participant's coverage. Interestingly, the maximum amount of reimbursement in a plan year for most FSAs (whether health FSAs or DCAPs) is 100% of the "premium" paid. While the language used is that of an insurance contract, insurance contracts typically offer at least the possibility that the amount paid out on the contract will far exceed the premiums paid. In the typical health FSA or DCAP, the maximum reimbursement equals the amount contributed. Thus, the employee can "lose", by contributing more to the FSA in premiums than are withdrawn in claims, but cannot "win" by receiving reimbursements in excess of the premium paid in given year.

[30] Prop. Treas. Reg. §1.125-2, Q&A 5 (no deferred compensation) and Q&A 7 (risk shifting features).

[31] Prop. Treas. Reg. §1.125, Q&A 7 (b)(8) expressly provides that the "uniform coverage rules" that apply to health FSAs do not apply to DCAPs. Thus, the rule in Prop. Treas. Reg. §1.125, Q&A 7(b)(2) providing that reimbursements will be deemed to be available at all times if "paid at least monthly or when the total amount of claims to be submitted is at least a specified, reasonable minimum amount (e.g., $50)" is not imposed expressly on DCAPs. Nonetheless, reimbursements under FSAs for incurred expenses may be subject only to "reasonable conditions."

which an employee does not file timely claims is forfeited.

Prop. Treas. Reg. §1.125-2, Q&A 7(c). Excessive delays between the time claims for incurred expenses are submitted and the time reimbursements are made likely would not be deemed to be "reasonable." See, Prop. Treas. Reg. §1,125-1, Q&A 14. Presumably, the uniform coverage rules are not considered necessary to limit the amount of benefit an employer will offer since DCAPs are subject to relatively low statutory limits on coverage. I.R.C. §129(a)(1). See note 20, *supra*.

§1.05 ELECTIONS DIFFICULT TO CHANGE DURING PLAN YEAR

The election to take a salary reduction in order to be able to pay for certain benefits with pre-tax money, or to take a cash out, once made, is difficult to change during the plan year.[32] Within a given level of salary reduction, however, the employee may have somewhat greater flexibility to change among related benefits, that is to select a different coverage option.[33]

If the cafeteria plan permits, the salary reduction and cash out elections may be modified within the plan year only if one of thirteen events occurs and the change is on account of and consistent with the event.[34] These events include:

(i) Change in status, including a change in marital status, change in the number of dependents, a change in employment status, a dependent's satisfying or ceasing to satisfy eligibility requirements, a change in residence, or the commencement or termination of adoption proceedings.

(ii) Cost changes with automatic election increases or decreases. For example, if premiums for health care insurance increase in the middle of the plan year by a small percentage, then

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[32] In addition to the changes permitted due to various changes in circumstances, discussed in this §1.01[7], plans generally permit plan administrators to reduce salary reductions of HCEs and key employees ("keys") if necessary to ensure that the plan will satisfy all applicable discrimination tests during the plan year. Since modifications after the end of the plan year are not permitted to correct for discriminatory results, these corrections must be made during the plan year if HCEs and keys are to retain the favorable tax treatment offered by a cafeteria plan. "Key employees" are defined and discussed in §1.05[1][b], *infra*.

[33] For example, an employee electing salary deferrals to pay for health care coverage may be able to change from an HMO to an indemnity plan if, in the middle of the plan year the employee's physician decides no longer to participate in the HMO. What cannot be changed, however, is the level of the employee's salary reduction for health care insurance. Thus, while the employee may be able to change from the HMO to the indemnity plan, the employee would not be able to increase salary deferrals in that plan year in order to pay the increased premium costs associated with the indemnity plan. Similarly, an employee could change the form of dependent care for a child from day care to in-home care but would not be able to increase or decrease the amount of the employee's salary reduction during the plan year in order to address the increased or reduced cost of the new form of care. This restriction runs counter to the overall structure of a cafeteria plan which provides employees the ability to select the benefits most needed and to tailor the amount allocated to that benefit based on ongoing need.

[34] Treas. Regs. §§ 1.125-3 and 1.125-4.

the employee may automatically increase salary reductions in order to be able to pay the excess premium with pre-tax dollars and maintain the level of coverage.

(iii) Significant cost changes. If the cost of a benefit increases or decreases substantially during the plan year, the employee may commence or terminate participation in the particular benefit. If the cost of a benefit decreases substantially, employees may choose to begin coverage. Conversely, if the cost of a benefit increases substantially, employees may terminate salary reductions connected with that benefit. Alternatively, an employee may switch from one option to another as a result of significant cost changes. For example, an employee with fee for service indemnity health care insurance might decide to switch to HMO coverage if the premium costs for the indemnity insurance increased significantly during the plan year and both types of insurance were offered by the cafeteria plan.

(iv) Significant curtailment of coverage (with or without total loss of coverage). If the nature of the benefit is significantly reduced (e.g., significant increase in co-pays or deductibles), the employee may select alternative coverage but coverage generally may not be terminated. If the provider terminates the benefit, then the employee may select alternative coverage or terminate salary reductions associated with the particular benefit.

(v) Addition or significant improvement of benefits package options. Conversely, if a coverage option improves significantly or if new options are made available during the plan year, employees may commence salary reductions in order to acquire the new or improved benefit.

(vi) Change in coverage in another employer's plan. If coverage by a plan available to a spouse or dependent changes significantly, and the plan years of the two plans are not comparable, then the employee may increase or decrease salary reductions in order to obtain or terminate coverage with respect to the particular benefit under the plan available to the employee. For example, if a husband and wife work for different companies, each of which offers health insurance under a cafeteria plan but the plan years are not coordinated, and the husband's plan offers in a new plan year a significantly improved health insurance option, then the wife may terminate salary withdrawals in the middle of her plan year in order to terminate health insurance coverage under her cafeteria plan so that the family can be covered solely under the husband's plan.

(vii) Loss of coverage under a group health plan of a governmental or educational institution. An employee may prospectively add coverage for the employee, spouse or dependent if the employee, spouse or dependent loses coverage under a group health plan sponsored by a governmental or educational institution (e.g., State Children's Health Insurance

Program[35]).

(viii) Leave Under Family Medical Leave Act ("FMLA").[36] An employee taking leave under the FMLA may revoke an existing election of group health plan coverage and make a different election for the remaining portion of the period of coverage provided under the FMLA.

(ix) Changes in 401(k) contributions. Although these changes are not technically event related, a cafeteria plan may permit an employee to modify or revoke his or her 401(k) contribution election during a plan year if the change is permitted under the 401(k) plan itself.

(x) HIPAA special enrollment rights. HIPAA requires group health plans to provide special enrollment periods (i) for individuals who declined participation because they were covered under a different group health plan at the regular enrollment time and later lost that coverage and (ii) for individuals who become dependents during the plan period through marriage, birth, adoption or placement for adoption.

(xi) COBRA qualifying events. An employee may increase salary reductions if the employee, spouse or dependent loses eligibility for regular coverage due to loss of dependent status or a reduction in hours of employment. For example, if an employee's child loses dependent coverage under a health plan but remains a dependent for income tax purposes, the employee may increase salary reductions in order to permit the child to obtain COBRA coverage.

(xii) Judgment, decree or order. An employee may change salary reductions as a result of a divorce decree, legal separation, annulment or legal change in custody under which a court order requires the employee, or another person, to assume certain health care coverage for a dependent.

(xiii) Medicare or Medicaid. An employee may prospectively reduce salary reductions upon becoming eligible for Medicare or Medicaid, or, if the employee loses eligibility for these programs, may prospectively increase salary reductions in order to replace medical coverage.

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[35] 42 U.S.C.A. §§1397aa-1397jj (West Supp. 2001), Balanced Budget Act of 1997, Pub. L. No. 105-33 (1997) (as amended) (added to the Social Security Act).

[36] Family Medical Leave Act of 1993, Pub. L. No. 103-3, 29 U.S.C.A. §§ 2601-2654 (West 1999).

For non-highly compensated employees ("NHCEs")[37] with minimal incomes, making an irrevocable election for an entire plan year may involve more financial risk than the employee can comfortably undertake. An employee living from paycheck to paycheck may be unwilling to reduce that paycheck for an entire year, knowing that he or she may not be able to reverse the election during that period. The virtually irrevocable nature of the election significantly reduces the effectiveness of the plan for lower income employees, which also makes it more difficult for HCEs and key employees to participate and satisfy the discrimination tests.[38]

§1.06 DISCRIMINATION RULES APPLICABLE TO CAFETERIA PLANS.

In order for participants and companies to obtain favorable tax treatment, cafeteria plans must satisfy certain requirements designed to ensure that the plans are not discriminatory and do not unduly favor highly compensated or key employee participants. In essence, the non-discrimination rules are designed to ensure that benefits available to highly compensated and key employees are also offered to non-highly compensated employees. They also require that non-highly compensated employees in fact receive a substantial portion of the benefits provided. Thus, the discrimination rules address issues of availability and actual utilization. While one could conceivably argue that these rules help rank-and-file employees of large companies (probably a difficult argument to make...), when applied to small business, the net effect often is that small businesses simply decline to offer cafeteria plans and employee benefits to any employees.

[1] Applicable Discrimination Tests

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[37] See discussion of highly compensated employees, §1.05[1][a], *infra*.

[38] Discrimination tests are discussed in §§1.05 and 1.06, *infra*.

Both the cafeteria plan and the component plans for each of the benefits offered in the cafeteria plan must comply with certain discrimination requirements. The two sets of discrimination tests may differ somewhat. For cafeteria plans, the discrimination rules impose three separate tests: (i) an eligibility test, (ii) a contributions and benefits test and (iii) a key employee concentration test. These tests are designed to determine whether highly compensated employees and key employees are disproportionately eligible for or actually receive disproportionate amounts of benefits.

[a] *Highly Compensated Employees*

"Highly compensated employees" are defined in I.R.C. §125(e) to include an employee who is an officer, a more than 5% shareholder, highly compensated employees and a spouse or dependent[39] of any of the foregoing.

The number of officers is limited to 50, or if there are fewer than 50 employees, then the greater of 3 employees or 10% of employees. Thus, in a very small business, e.g., one with 25 employees, if there are 3 officers, then more than 10% of the employees would be HCEs on this basis alone, thereby making it difficult for the company to comply with the nondiscrimination tests. While technically only corporations have "officers," for purposes of identifying "highly compensated employees," sole proprietorships, partnerships, associations and other unincorporated entities are also treated as having "officers."[40] The types of factors taken into account in determining who is an "officer" are the source of a person's authority, the term for which he or she is elected or appointed, and the nature and extent of the individual's

[39] For these purposes, the class of individuals considered to be dependents is determined pursuant to I.R.C. §152.

[40] Treas. Reg. § 1.416-1, Q&A T-15.

responsibilities.[41]

A more than 5% stockholder includes any stockholder owning more than 5% of the voting power or 5% of the value of all classes of stock of the employer in either the current or preceding plan year. In determining who is a more than 5% stockholder, stock subject to an option (whether the stockholder owns the option or has an option to own the option) is also attributed to the stockholder.[42] In an unincorporated entity, ownership is determined by taking into account interests in the capital or profits of the employer.

While I.R.C. §125(e) does not define "highly compensated," the standard applicable to 401(k) plans is that which is generally used.[43] For 2002, employees earning more than $90,000 per year are deemed to be highly compensated, and for 2001, the compensation limit is $85,000. The general approach is to compare the prior year's compensation to the prior year's compensation limit. Thus, except for fiscal year plans that make a calendar year data election,[44] the 2002 threshold of $90,000 will be compared to an employee's 2002 compensation when testing for the 2003 plan year, and the 2001 threshold of $85,000 will be compared to an employee's 2001 compensation when testing for the 2002 plan year.[45] Note that the attribution rules under I.R.C. §318 must also be taken into account when determining which employees

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[41] I.R.C. §416.

[42] I.R.C. §318(a)(4).

[43] I.R.C. §§ 401(k)(5) and 414(q). In the absence of written guidance by the Treasury, practitioners often apply concepts and definitions from the laws and regulations governing qualified retirement plans to cafeteria plans. This practice, although common, must be undertaken with caution where the existing laws or regulations do not expressly refer to qualified retirement plan concepts.

[44] I.R.S. Notice 97-45, 1997-33 IRB 7.

[45] I.R.C. §414(q).

own more than 5% of the employer's stock.[46] Companies with a large number of employees receiving incomes over the annual compensation limitations can reduce the number of employees considered "highly compensated employees" by making certain elections limiting employees who are considered to be in the "top–paid group.[47]

[b] *Key Employees*

The concept of key employees was developed in the context of qualified retirement plans to determine whether a retirement plan is top–heavy and thus subject to the top-heavy rules. Except for the cafeteria plan, the concept of a key employee is not applied to other types of employee benefits. For purposes of cafeteria plans, "key employees" are defined[48] as officers[49] having annual compensation[50] greater than $130,000 (indexed for inflation), a more than 5% owner[51], or a more than 1% owner having

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[46] Id.

[47] Employees who received compensation in the preceding plan year in excess of the I.R.C. §414(q) amount for that year and (if elected by the employer) were also in the "top-paid group," that is, generally in the top 20% of all employees, are also included in the definition of "highly compensated employee." This election can assist companies with large numbers of employees with large salaries in reducing the number of employees actually treated as "highly compensated employees" for discrimination testing purposes. I.R.S. Notice 97-45, 1977-33 I.R.B. 7, at Section VII.

[48] The definition of "key employees" was changed by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGGTRA), Pub. L. No. 107-16, for plan years 2002 and later.

[49] The concepts applicable when determining who is an "officer" for purposes of identifying highly compensated employees also apply in the context of identifying key employees.

[50] For definitions of "compensation" see I.R.C. §414(q) and Treas. Regs. §§1.415-2(d) and 1.416-1, Q&A T-21. An employee's Form W-2 for the calendar year ending with or within a plan year may also be used.

[51] As in the concept of "highly compensated employee," the ownership concepts involved in the definition of "key employee" take into account both voting power and value of all classes of stock (or other ownership) of the company.

annual compensation of more than $150,000 (not indexed).[52] In determining both more than 5% owners and more than 1% owners, the constructive ownership rules of I.R.C. §318 are applied. Thus, in a small business, a spouse working two days a week could be considered a key employee simply because the other spouse is a more than 5% owner.

[2] Eligibility Test

The eligibility test[53] determines whether a sufficient number of non-highly compensated employees are eligible to participate in the plan. This test is satisfied if (i) the cafeteria plan benefits a non-discriminatory classification of employees,[54] (ii) the same employment requirement applies to all employees, (iii) no more than three years of employment is required for participation, and (iv) participation is not delayed beyond the first day of the plan year after the employment requirement is satisfied.[55]

To be non-discriminatory, a classification used to determine eligibility to participate in a cafeteria plan must be reasonable and based on objective business criteria such as job categories, nature of compensation (salaried or hourly wages) or geographic location. In addition, the classification may not have a discriminatory effect, that is, regardless of its objective apparent reasonableness, it generally may

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[52] I.R.C. §125(b)(2) expressly incorporates the definition used in I.R.C. §416(i). Note that the compensation limits for determining key employees in the cafeteria plan context are thought not to refer back to the preceding year (in contrast with the top heavy rules in the retirement plan context). Thus, the 2002 compensation limits are thought to apply to the 2002 cafeteria plan year for purposes of identifying key employees. Similarly, the data used for identifying the officers of a company, for purposes of identifying key employees, would be data from the plan year being tested. McCormick and Hickman, Cafeteria Plans, Employee Benefits Institute of America, LLC, Vol. I, p. 860-c (2002).

[53] I.R.C. §125(b)(1)(A).

[54] For purposes of I.R.C. §125, a non-discriminatory classification of employees is one that the I.R.S. determines is not discriminatory in favor of highly compensated employees. I.R.C. §410(b)(2)(A)(i).

[55] I.R.C. §125(g)(3).

not result in the percentage of NHCEs eligible to participate in the plan being less than 50% of the percentage of eligible HCEs (although there are some exceptions). Having separate cafeteria plans for salaried and hourly employees, for part time and full time employees, for employees in different divisions of a company generally is not acceptable.

[3] Contributions and Benefits Test

The contributions and benefits test[56] has three components. The "availability" test determines whether each eligible employee who decides to participate in the plan is given an equal opportunity to select qualified benefits. In other words, it ensures that benefits are equally available to all participants. The "utilization" or "concentration" test looks at the actual operation rather than the plan design to determine whether HCEs actually receive disproportionate benefits (essentially because NHCEs are not participating at a sufficiently high rate). This test determines whether HCEs "disproportionately select" non-taxable benefits while NCHEs select taxable benefits.[57] The "operations" test looks at whether the plan discriminates in favor of HCEs in actual operation, for example, because a benefit is offered only during a period in which HCEs can utilize the plan.

[4] Key Employee Concentration Test

The key employee concentration test requires that qualified benefits provided to key employees not exceed 25% of the total of all benefits provided for all employees under the plan. As in the retirement plan context, the cafeteria plan discrimination tests involving key employees generally impact only small

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[56] I.R.C. §125(b)(1)(B).

[57] Prop. Treas. Reg. §1.125-1, Q&A 19. The IRS has not provided clear guidance or any objective test for determining whether HCEs have disproportionately selected non-taxable benefits in comparison with the selection of non-taxable benefits by NHCEs. This lack of an objective standard was one reason Congress gave for enacting the key employee concentration test in 1984. See, General Explanation of the Tax Reform Act of 1984, prepared by the Staff of the Joint Committee on Taxation, p. 868 (1984). I.R.C. §125(g)(2), however, provides a safe harbor for cafeteria plans that provide health benefits. These plans will not be treated as discriminatory under the contributions and benefits test if (a) contributions under the plan on behalf of each participant (i) equal 100% of the cost of health benefit coverage of a majority of the highly compensated participants similarly situated, or (ii) equal or exceed 75% of the cost of coverage of the participant (similarly situated) having the highest cost health benefit coverage under the plan, and (b) contributions or benefits in excess of these amounts bear a uniform relationship to compensation.

business plans. Small business plans have difficulty satisfying the key employee concentration test since, as a general rule of thumb, that test is difficult to satisfy if key employees represent 10% or more of the total number of employees. Even if all eligible employees participate and elect a particular benefit, the plan may be "discriminatory" under the key employee concentration test simply because the company has a large proportion of key employees compared with non-key employees. This is often the case in smaller businesses.

For example, if a company has 3 key employees, each of which elects $2,000 of nontaxable benefits under a plan, and 7 non-key employees, each of which elects the same $2,000 of nontaxable benefits, the plan will fail the key employee concentration test ($6,000/20,000 = 30% of benefits attributable to key employees, significantly in excess of the 25% threshold that benefits received by key employees may represent of total benefits received by all employees). From a policy viewpoint, it is difficult to justify the application of this test when all employees are able to select from the same benefits and choose to reduce their salaries by the exact same amount and/or apply the same employer cafeteria plan dollars. It is hard to conceive of a less discriminatory plan.

[5] Consequence of Failing Discrimination Tests

If the cafeteria plan fails any of the discrimination tests, then HCEs and key employees who participate in the plan must include in income the highest value of taxable benefits that the individual could have selected under the cafeteria plan, including both the maximum available cash-out amount (if any) and any actual salary reductions.[58] NHCEs, however, may continue to exclude the benefits from income.

[58] Prop. Treas. Reg. §1.125-1, Q&A 10.

§1.07 DISCRIMINATION TESTS APPLICABLE TO UNDERLYING BENEFITS

Each of the benefits offered in a cafeteria plan is subject to its own set of discrimination tests. Because this chapter focuses on the use of cafeteria plans to enable employees to finance dependent care for children and elderly parents and to purchase long term health insurance for themselves and their spouse, this article will focus solely on the four discrimination tests applicable to DCAPs: (i) the eligibility test, (ii) the contributions and benefits test, (iii) the more than 5% owner concentration test and (iv) the 55% average benefits test. Essentially, if the DCAP discriminates in favor of HCEs of certain shareholders or owners of the employer, benefits provided to HCEs will be included in their income.[59]

[1] Eligibility Test for DCAPs

The classification of employees eligible to participate in the DCAP must not discriminate[60] in favor of HCEs or their dependents.[61] The definition of "highly compensated employees" for purposes of the eligibility test for DCAPs differs from the definition used for discrimination testing of cafeteria plans.[62] In

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[59] I.R.C. §129(a)(1) and (d)(1). The IRS has not issued separate regulations governing the application of nondiscrimination rules to DCAPs.

[60] Generally, the I.R.C. §410(b) nondiscriminatory classification test is used to determine whether a classification is discriminatory. Under Treas. Reg. §1.410(b)-4(a), a plan satisfies the nondiscriminatory classification test only if (i) the plan benefits employees who qualify under a reasonable classification (e.g., one that is based on objective business criteria) and (ii) the classification of employees meets a percentage test demonstrating that it is not discriminatory. Certain safe harbors have been established to provide employers assurance regarding whether or not the plan satisfies the eligibility test. Treas. Reg. §1.410(b)-4(c)(2).

[61] I.R.C. §129(d)(3). Because DCAPs are not subject to the "uniform coverage" rule applicable to health FSAs, the employer does not run the risk of having to reimburse an employee at any time during the year an amount in excess of that set aside in the employee's account. This feature encourages employers to make all employees (other than excludable employees such as those who have not attained age 21 or completed a year of service) eligible for participation. As discussed in note 20, *supra*, the uniform coverage rule is not needed to limit the amount of benefit available under a DCAP since that amount is limited by statute to $5,000 per eligible employee or $2,500 per year in the case of a married person filing separately. I.R.C. §129(a)(1).

[62] For purposes of a DCAP, HCEs are defined in I.R.C. §414(q). I.R.C. §§129(d)(2) and (3). As previously mentioned, I.R.C. §125(e) does not define "highly compensated employee" and most practitioners utilize concepts

the DCAP context, an HCE is defined as an employee who owns more than 5% of the shares (or value) of the company or receives compensation from the company in excess of $90,000 for plan year 2002 or $85,000 for plan year 2001.

[2] Contributions and Benefits Test

Available benefits and permissible contributions may not favor HCEs.[63] In other words, the contributions and benefits test is designed to ensure that HCEs are not eligible to receive greater benefits than NHCEs or permitted to make smaller contributions for equivalent benefits as compared to NHCEs. Accordingly, this test may be satisfied by using the same maximum benefits and contribution limits for both HCEs and NHCEs. This test does not look at utilization rates, but simply compares the quality of benefits offered to the two groups and the cost of comparable benefits charged the two groups.

[3] More than 5% Owner Concentration Test

No more than 25% of the total amount paid or incurred by the employer for dependent care assistance during the plan year may be paid to the group of individuals who are more than 5% shareholders (including their spouses and dependents).[64] If this discrimination test is not satisfied, all HCEs, not merely employees who are more than 5% owners, will need to include DCAP amounts in gross income.[65] While this concentration test seems to mimic the key employee concentration test which is applicable to cafeteria

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developed in the context of qualified retirement plan.

[63] I.R.C. §129(d)(2).

[64] I.R.C. §129(d)(4).

[65] I.R.C. §129(d)(1).

plans,[66] in fact these are two separate tests. The cafeteria plan test assesses the concentration of benefits provided to key employees, while the DCAP test assesses the concentration of benefits provided to more than 5% stockholders. While there may be some de facto overlap in the two categories, cafeteria plans offering DCAPs must satisfy both tests separately. The use of two separate concentration tests in this context is an example of the complexity of discrimination testing that makes small business shy away from cafeteria plans as too complicated and costly to administer. It is not clear what additional benefit is afforded NHCEs by imposing the additional level of discrimination testing.

[4] 55% Average Benefits Test

The 55% average benefits test is also a utilization test. Under this test, the average DCAP benefit provided to all NHCEs must be at least 55% of the average benefit provided to all HCEs.[67] While the more than 5% owners concentration test compares aggregate benefits of the two groups of employees, the 55% average benefits test compares the average benefit received by all NHCEs with the average benefit received by all NCEs, requiring that the average benefit received by all NHCEs be at least 55% that of the average benefit received by all HCEs. Included in the value of benefits received are only those amounts actually reimbursed for dependent care, not the amount (including any forfeited amount) of salary reduction.[68]

Again, an example may be useful. Assume that a company has ten employees, two of whom are HCEs. Assume that all employees are eligible to participate in the DCAP and that each participating

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[66] The key employee concentration test is discussed at §1.05 [4], *supra*.

[67] I.R.C. §129(d)(8).

[68] Prop. Treas. Reg. §1.125-1, Q&A 11 and Q&A 18.

employee elects a salary reduction of $5,000 and actually receives $5,000 of dependent care reimbursements. Assume that both of the HCEs participate, but only three of the NHCEs participate. The average benefit for the HCEs is $5,000, that is, [($5,000 + $5,000) ÷ 2 = $5,000]. The average benefit for the NHCEs is $1,875, that is [($5,000 + $5,000 + $5,000 + 0 + 0 + 0 + 0 + 0) ÷ 8 = $1,875]. The average benefit provided to NHCEs is thus 37.5% of the average benefit provided HCEs ($1,875 ÷ $5,000 = .375) and the DCAP fails the 55% average benefits test.

Certain employees may be excluded from the 55% average benefits test, making it somewhat easier to satisfy. Employees under the age of 21, employees who have not completed a year of service, and employees in a collective bargaining unit for which there has been good faith bargaining over dependent care benefits may be excluded. In addition, if the DCAP is provided through a salary reduction program, employees with compensation of less than $25,000 also may be excluded.

[5] Utilization Tests Difficult To Satisfy

Both the more than 5% owner concentration test and the 55% average benefits test can be difficult to satisfy. In general, DCAPs have a relatively low utilization rate. While on average 20% to 50% of eligible employees participate in health FSAs, only about 2% to 6% of eligible employees participate in DCAPs.[69] This low participation rate is due, in part, to the fact that only certain segments of the population can benefit from a DCAP: only certain individuals have children under age 14 or elderly dependents and need dependent care assistance in order to be able to seek employment. NHCEs, however, in particular are less likely to use DCAPs than other benefits because only employees with lower salaries qualify for the

[69] McCormick and Hickman, Cafeteria Plans, *supra*, Vol. I, Chapter V, p. 106 (2002).

dependent care tax credit[70] and this tax credit is often more advantageous than the DCAP. Since in most circumstances taxpayers are not able to utilize both benefits,[71] NHCEs needing dependent care assistance often select the dependent care tax credit rather than the DCAP, a choice not available to HCEs who, because of their greater income, do not qualify for the tax credit. Accordingly, even though the DCAP may be available on a non-discriminatory basis, unless a significant portion of a company's employees needing dependent care assistance have family incomes sufficiently large to preclude their use of the dependent care tax credit,[72] HCEs are unlikely to be able to take advantage of this significant benefit.

To address this issue, DCAP plans provided through a salary reduction program are permitted to exclude from eligibility employees with compensation of less than $25,000.[73] This figure, however, is not indexed for inflation and has not been changed since the dependent care credit was first enacted. Moreover, EGGTRA changed the credit to make it more advantageous to middle income taxpayers,[74] thereby making it even more difficult for DCAP plans to satisfy the utilization tests.

Small businesses, in particular, may find the more than 5% shareholder concentration test and the 55% average benefits test difficult to satisfy. As the total number of employees decreases, the likelihood

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[70] I.R.C. §21.

[71] I.R.C. §21(c).

[72] Generally, taxpayers with a marginal tax bracket greater than 15% do better with a DCAP than with the dependent care tax credit. For married couples filing jointly, this represents taxable income over $36,900.

[73] I.R.C. §129(d)(8)(B).

[74] For example, effective in 2003, EGGTRA increased the maximum percentage of eligible employment related expenses which a taxpayer may take into account when using the dependent care credit to 35% from 30%. The actual percentage which a taxpayer may take into account declines as the taxpayer's income increases. EGGTRA also increases the amount of expenses per dependent which are considered eligible expenses from $2,400 to $3,000 for one dependent (and up to $6,000 for two dependents).

that any one group of employees might have a utilization rate that varies from the average increases significantly. The larger the group, the more the participation rates will tend toward the average. In essence, in a small business, relatively small changes in the number of NHCEs and HCEs who are interested in participating in a DCAP are more likely to disqualify the HCEs from achieving preferred tax treatment than would changes by the same number of employees at a larger company. This point can be understood more easily by an example. Let us assume that 5% of all employees in the U.S. would be interested in taking advantage of DCAPs and, for purposes of this example, let us assume that this percentage does not systematically change with income levels. (In other words, this example is<u>not</u> taking into account the disparate impact of the dependent care tax credit on HCEs in comparison with NHCEs.) In one company with 10,000 NHCEs, approximately 500 will want to participate. Similarly, in 1,000 small businesses with 10 NHCEs each, approximately 500 will want to participate. But in many of the small businesses with 10 NHCEs each, the number of NHCEs wanting to participate could be significantly more or less than 5. (Similarly, if the participation rate by HCEs nationally were, let us say 20%, and a small business had 10 NHCs, the number of HCEs in a particular small business wanting to participate could be significantly more or less than 2.) In each of these situations, because the total number of HCEs and the total number of NHCEs is relatively small, the actual participation rates by HCEs and NHCEs in a particular small business may differ significantly from the national average, and many of these smaller businesses will be unable to satisfy the utilization tests. These companies would thus be unable to make the benefit available to their HCEs, and the small business could very well lose interest in offering the benefit to any of its employees.

[6] Consequence of Failing Discrimination Tests

If the DCAP fails any of the discrimination tests, then HCEs and key employees will be required to include their DCAP benefits in gross income.[75]

§1.08 MANY SMALL BUSINESS OWNERS ARE PROHIBITED FROM PARTICIPATING IN CAFETERIA PLANS.

Another factor that discourages small businesses from offering cafeteria plans is that self-employed individuals, such as sole proprietors, more than 2% shareholders in a Subchapter S corporation ("Sub-S corporation"), members in a limited liability company ("LLC") and partners in a partnership are precluded from participating in cafeteria plans.[76] For purposes of cafeteria plans, these individuals are not considered "employees."[77]

Many small businesses are organized as sole proprietorships, Sub-S corporations, partnerships or LLCs. Unlike large, publically traded corporations (generally C corporations), which are typically owned by outsiders (pension plans, insurance companies, mutual funds and individual investors), small businesses typically are owned by key employees or highly compensated employees. In contrast with a large, publically traded company, in which ownership and management often are separated, in a small business,

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[75] I.R.C. §§129(a)(1) and 129(d)(1). The cafeteria plan nondiscrimination rules require the HCEs to include in gross income any amount that could have been received as cash, that is, the total salary reduction amount, whereas the DCAP nondiscrimination rules only require the HCE to include amounts actually received as dependent care assistance.

[76] The spouse of a sole proprietor or partner, however, may participate in a cafeteria plan if the spouse is a bona fide employee who meets the eligibility requirements and the value of coverage is reasonable in relation to the services rendered. For purposes of discrimination testing, however, the spouse will be deemed to be a highly compensated employee and a key employee, regardless of the compensation earned by the spouse. The spouse/employee may thereby indirectly afford benefits to the sole proprietor or partner as a member of the employee/participant's family. The spouse of a more than 2% shareholder of a Sub-S corporation may not participate in a cafeteria plan, however, because of the ownership attribution rules of I.R.C. §318.

[77] Prop. Treas. Reg. §1.125-1, Q&A 4. The term "employees" does not include self-employed individuals described in I.R.C. §401(c). See also, I.R.C. § 1372(a) with respect to more than 2% shareholders of a Sub-S corporation.

ownership generally is not separated from management and operation of the business. When owners of small businesses realize that they will not be able to benefit from cafeteria plans which they might want to offer to their employees, they simply lose interest.[78]

§1.09 CAFETERIA PLANS ARE IMPORTANT TOOL FOR SMALL BUSINESS

[1] Cafeteria Plans Are Valuable Employee Benefit

The cafeteria plan is a unique employee benefit delivery system in that it allows employees to select from a number of benefits those benefits and/or mix of benefits most needed by the employee.[79] Often not appreciated is that the cafeteria plan brings group plans of various benefits to employees at prices which employees could not otherwise obtain. As described above[80], each underlying benefit offered under a cafeteria plan is tested, in accordance with the rules set forth in the Code for that particular benefit, to make sure it is not discriminatory. Paradoxically, benefits bundled together in a cafeteria plan are subject to yet another layer of discrimination tests simply because the benefits are offered under a cafeteria plan umbrella. Not only are many of these rules unnecessary; they cause small businesses to not provide cafeteria plans for their employees. Rather than ensure that benefits are available to all employees, these tests, particularly in the context of small business, often result in benefits being available to none.

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[78] A similar problem arises with respect to group term insurance and disability income insurance. Partners and self-employed individuals are not deemed to be "employees" for group term life insurance or for disability income insurance, whether or not these benefits are offered through a cafeteria plan vehicle. Excluding these individuals from using pre-tax dollars to acquire these benefits dampens enthusiasm to offer these benefits to other company employees.

[79] Indeed the name of this plan, "cafeteria" plan, reflects the flexibility and selection of benefits inherent in this employee benefit.

[80] See §1.06, *supra*.

[2] Cafeteria Plans Are Not Widely Offered by Small Business

According to the US Small Business Administration ("SBA")[81], in 2001 small businesses represented over 99% of all employers, created about 75% of net new jobs and accounted for 51% of the private sector output. Further, the SBA estimates that in 2001 small businesses employed 51% of the private sector work force and 51% of workers on public assistance, and they represented nearly all of the self-employed, which were 7% of the workforce. Yet few of the employees working for a small business have access tohealth insurance, dependent care insurance, health FSAs or other important benefits, in part because the company does not sponsor a cafeteria plan.

Section 125 plans are available to roughly one third of all of the nation's employees.[82] Approximately 13% of employees who work for companies with fewer than 50 employees are covered by a cafeteria plan. 33% of employees who work for companies who employ between 50 and 100 employees are covered by this type of plan. This percent stays roughly the same until one reaches companies who employ more than 1000 but fewer than 2,500 employees: 49% of the employees of these businesses are covered by cafeteria plans. 61% of employees who work for businesses that employ more than 2,500 employees are covered by cafeteria plans.[83]

[3] Small Business Needs Cafeteria Plans

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[81] Small Business - Frequently Asked Questions, August, 2001, US Small Business Administration, Office of Advocacy.

[82] News, United States Department of Labor, Bureau of Labor Statistics, Washington, D.C., USDL: 01-473, December 19, 2001.

[83] Id. Section 125 plans for purposes of these statistics include flexible benefit plans, reimbursement accounts and premium conversion plans.

When a company chooses to provide a portion of health insurance coverage for its employees, but does not pay the entire premium, the cost of the premium paid for by the employees can be paid for with pre-tax dollars *only if* the company sponsors a cafeteria plan and offers health insurance as a benefit under the plan. This type of plan is often referred to as a "premium conversion" plan (described in more detail in §1.02[3], *supra*). Conversely, if the company does not a cafeteria plan, the employee must use after-tax dollars to pay for the employee's portion of the premium. Because cafeteria plans allow employees to acquire valuable benefits using pre–tax dollars and/or employer dollars, cafeteria plans are considered to be a viable means of providing additional health and other benefits for employees and their families than the employees would otherwise be able to afford.

Not surprisingly, cafeteria plans are very popular with employees. Because employees can afford under a cafeteria plan a variety of benefits which they often cannot afford if offered only as an individual plan, and because employees generally are able to select only those benefits which they want, cafeteria plans assist employees in obtaining a wide variety of important benefits at an affordable cost. Companies can offer dental, vision, life and supplemental insurances that would be otherwise too expensive for their employees. The cafeteria plan can offer flexible health care spending accounts which allow employees to pay for deductibles and co-pays on a pre-tax basis. Often dependent care spending accounts are offered in the cafeteria plan to help employees pay for child care and elder care. With the aging of the baby boomers, and thus the aging of their parents, the dependent care spending account for elder care is going to become an increasingly more valuable benefit for employees.

Some employee benefits counselors believe that employees appreciate and value benefits more when they have assigned dollars to them through the employee selection process. Others believe that when

employees are using their own dollars and have a choice of various health care delivery systems, they are more cost-conscious consumers of health care.

Of real importance to the small business, however, is that a cafeteria plan can allow the small business to offer more benefitsto its employees, so thatthe business is more able to "match" the benefits provided by larger employers and attract valued employees. Former employees of larger companies are often dismayed, when engaged by a small business, to find that their new employer does not offer a cafeteria plan and they, accordingly, are no longer able to select the benefits they want and pay for them with pre-tax dollars. This disparity in treatment between the employees of large and small business entities has no policy justification. The compensation of the highest paid employees in small businessesoften is in line with that of mid-management at larger companies. Thus, an employee who is not a highly compensated employee in his position with a large company may suddenly find, when moving to a small business, that with no increase in compensation, he has suddenly become a highly compensated employee. While the benefits which the employee had received under a cafeteria plan in the larger company were not under scrutiny in discrimination testing, simply because the same employee, when joining a small business, suddenly becomes part of the "prohibited group," these same benefits may lose their pre-tax status. Given the need to increase access tohealth insurance, dependent care insurance and other important benefits, the concern that a highly compensated small business employee might receive a tax-free benefit, and thereby reduce income, FICA and FUTA revenues, must be weighedagainst the benefits that can be delivered to all of the small business employees. The authors believe that expanding access to critical benefits through a private sector approach rather than public sector funds is an important public policy objective that can be fostered by creating a framework that encourages, rather than discourages, small business to offer employee benefits through the

cafeteria plan umbrella.

§1.10 CHANGES NEEDED IN THE CAFETERIA PLAN AREA TO INCREASE SMALL BUSINESS PLAN COVERAGE

[1] Variety of Factors Discourage Small Businesses From Offering Cafeteria Plans

Cafeteria plans are generally not available to small business employees. This is due to a number of different factors. As discussed above, many small business owners are not even allowed to participate in their own cafeteria plan.[84] Anti-discrimination tests often cut back the benefits of those small business owners who can participate to insignificant amounts.[85] Complex rules, such as when an employee can change an election during a plan year[86], add to the problem. Finally, employees may be reluctant to allocate their own money to a benefit knowing if they do not "use" the money, they will "lose it" -- their money will be allocated to the general funds of the company.[87]

[2] "Use it or Lose it" Rule Discourages Optimum Level of Employee Elective Deferrals

Complexity in the cafeteria plan area, perhaps more than with respect to any other employee benefit, is caused by IRS regulations. When a cafeteria plan is viewed through the "tax lens" rather than as a vehicle providing valuable benefits for employees, one can end up with bizarre results. Thus, rules such as the "use it or lose it" rule, which seem to have been driven by the Treasury,[88] are counterproductive when

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[84] See §1.07, *supra*.

[85] See, generally, §§1.05 [5] and 1.06 [6], *supra*.

[86] See §1.04, *supra*.

[87] See §1.02 [4], *supra*.

[88] The Proposed Regulations require that health FSAs and DCAPs include a measure of risk shifting on the part of both the employer and the employee in order to get around the concepts of "constructive receipt" of the

viewed through the eyes of the employees and with respect to their impact on employee behavior. Employees may deliberately allocate fewer dollars to a health FSA than they think they actually need because they are fearful of losing their own money. From the viewpoint of the fisc, at least in the short term, this is good policy because employees are sheltering fewer wages from taxes than they would otherwise but for this rule. From the viewpoint of health care costs and preventative medicine, however, this is a short term gain at best. If an employee defers insufficient funds into a health FSA because of the risk of losing the money, and then forgoes a needed medical test or procedure because it was not covered by insurance and the employee had not allocated sufficient dollars to the health FSA, then often the taxpayers as a whole (society) will bear the costs in the future for the care of diseases not discovered or properly treated at an earlier stage.

[3] Sole Proprietors, Partners, Limited Liability Members and Subchapter-S Stockholders Should Be Considered Employees and Allowed to Participate in Cafeteria Plans

As mentioned above, sole proprietors, partners, members of limited liability companies and most stockholders in a Sub-S corporation are not allowed to participate in a cafeteria plan.[89] These types of entities represent a significant portion of American business and, for the most part, represent small and medium sized firms. For example, last year about 25.4 million non-farm business tax returns were filed.

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income and the requirement that a cafeteria plan not offer deferred compensation. Prop. Treas. Reg. §1.125-2, Q&A 7. Essentially, the constructive receipt doctrine provides that an individual who has a choice between a non-taxable benefit (e.g., health insurance) and a taxable benefit (cash or wages), and who elects the non-taxable benefit will be treated for income tax purposes as if he or she had elected the taxable benefit instead. The individual is taxed on the taxable benefit he or she could have elected. To avoid this result and avoid the treatment that the elective deferrals involved in health FSAs and DCAPs represent deferred compensation, IRS justifies the imposition of the "use it or lose it" feature.

[89] See §1.07, *supra*.

Of these, 17.9 million were sole proprietorships, 2.0 million were partnerships and 5.5 million were corporations.[90] Thus, approximately 78% of all non-farm businesses are organized in a manner under which the owners of the business are not permitted to participate in a business sponsored cafeteria plan.

To the extent that the owners of these entities are also employees of the entities, the owners will be discouraged by this rule from offering cafeteria plans in which they, themselves, cannot participate. This rule discriminates against business owner/employees based solely upon the type of entity in which they are operating their business. To the extent that these entities are small or medium sized businesses, this rule makes it less likely that cafeteria plans will be available to employees of small and medium sized businesses. Because these entities choose not to sponsor a cafeteria plan, this rule works a particular hardship on the employees of small businesses. As a result, most employees of small businesses do not have available on a pre-tax, more affordable basis many of the basic benefits provided primarily through employment to employees of larger corporations.

To encourage small businesses to offer cafeteria plans, it is important that the owners of the more typical small business entities be considered "employees" for purposes of cafeteria plans. As long as they are considered "employees," they can be covered by a cafeteria plan. As potential participants in the cafeteria plan, they would be more likely to sponsor the plan. It seems inherent in human nature, and clearly an understandable decision, that an owner would lose interest in a plan that costs money to implement and administer and therefore reduces profits if the owner is excluded from participating in the plan.

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[90] Small Business - Frequently Asked Questions, August, 2001, US Small Business Administration, Office of Advocacy. While this is not clear, it appears that the 5.5 million corporations include Sub-S corporations as well as C-corporations.

Strangely enough, it appears that small business owners could participate in some of the permissible benefits offered under a cafeteria plan, *but for* the cafeteria plan umbrella placed on top of the benefits. For example, if a DCAP were offered outside the cafeteria plan, most experts believe that these small business owners could participate in the plan. Once it is included in the cafeteria plan, however, they cannot.

[4] Change the Cafeteria Plan Discrimination Rules so that Owners Can Benefit

Because of the dollar limitations and other discrimination rules imposed on many of the benefits offered under cafeteria plans, these plans are inherently non-discriminatory before being bundled into the cafeteria plan. Bundling these benefits into a cafeteria plan cannot per se create discrimination. To the contrary, as we have seen, each plan participant has the ability to reduce his or her compensation by the same dollar amount (not a percentage of compensation) and/or receive the same amount of employer dollars and then use these amounts to select among the employee benefits provided in the plan. Because the amount of compensation an employee may elect to defer or the amount of employer contribution the employee may receive is the same for all employees and is not tied to the level of compensation, the contribution amounts inherently provide proportionately greater benefits to low income employees than to HCEs. In other words, the benefits to lower income employees are greater, in relationship to their wages, than the benefits provided to HCEs. For example, a $5,000 benefit would equal 20% of the wages of a worker earning $25,000 per year but only 5% of the salary of an employee earning $100,000 per year. *It is hard to imagine a plan less discriminatory than a cafeteria plan.* Under a cafeteria plan, each individual benefit

is separately tested under its own discrimination rules set forth in the Code.[91] Nevertheless, the cafeteria plan is subjected to additional tests for all the benefits in the aggregate.[92] For example, the key employee concentration test requires that no more than 25% of the total benefits used by the plan participantscan be allocated to key employees as defined under I.R.C. §416(i). As we have seen, many small businesses are unable to satisfy this test simply because in small businesses key employees tend to represent a larger proportion of total employees than they do in larger entities.[93] Because the ability of a business to satisfy this test depends so highly on the mix of employees, it does not serve to measure "fairness" or "discrimination" in the cafeteria plan. For larger entities, it is essentially a meaningless test. For smaller businesses, however, it is a critical deterrent. The key employee concentration test provides no meaningful protection to non-key employees and significantly discourages small business cafeteria plan formation.

[5] Change the Dependent Care Discrimination Rules

Benefits offered under a cafeteria plan are subject to two layers of discrimination testing. One set of tests applies to the benefit itself, whether or not provided through a cafeteria plan. The second applies simply because the benefit is offered through the umbrella of the cafeteria plan. While the stated goal of these discrimination tests is to ensure that benefits are not offered to and utilized by primarily the highly paid employees, the effect often is that the benefits are not offered at all. Perhaps the most egregious example of this duplicative, costly and confusing layering of discrimination tests arises in the context of the dependent care assistance plan offered through the cafeteria plan vehicle. Three separate concentration tests apply:

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[91] See §1.06 , *supra*.

[92] See §1.05, *supra*.

[93] See §1.05 [4], *supra*.

the more than 5% owner concentration test and the 55% average benefits tests applicable to DCAPs and the key employee concentration test applicable to all benefits offered under a cafeteria plan. Each of these concentration tests is an actual utilization test. The issue is not whether benefits are fairly offered to a wide range of employees but whether a sufficient percentage of NHCEs actually take advantage of the benefits offered. These tests, and outdated limits on the maximum benefit that may be offered, need to be changed in order to encourage small business to offer DCAPs to their employees.

[a] *$5,000 Benefit Limit Needs to Be Increased for Inflation.*

The DCAP has a $5,000 benefit limit per employee. This dollar limit has been in place for the last 20 years. It is simply not realistic to think that employees can get quality child care or elder care today for $100 a week. Clearly, this limitation needs to be increased significantly to keep up with the realistic costs of child or elder care today.

[b] *Discrimination Tests Should Be Eliminated to Account for Impact of Dependent Care Tax Credit.*

As previously mentioned, the 5% owner concentration test and the 55% average benefits test are particularly difficult tests to satisfy primarily because of the dependent care tax credit.[94] Imposing a discrimination test which is failed not because of discrimination or any action by the employer, but because of a competing, essentially mutually exclusive tax credit which provides lower income employees better benefits than they can receive through the DCAP is simply bad policy. If offering lower income employees a dependent care tax credit, and phasing out this tax credit for higher income employees is deemed to be

[94] See, §1.05 [6], *supra*.

good policy, then it is undesirable and unfair that the dependent care tax credit would result in reducing or eliminating the availability of the DCAP for HCEs.

Because the DCAP under a cafeteria plan allows each employee to reduce his or her salary by the exact same amount or use the same amount of "cafeteria plan" dollars, all of these limitations (except for the dollar cap) operate as unnecessary and additional hurdles for this valuable benefit. Even though the focus here is on small business, apparently these tests often cause much larger plans to fail the anti-discrimination tests as well. Since the DCAP benefit can allow employees to provide higher quality child care or care for elderly parents than they could otherwise afford (since the benefits are not taxed if the plan is qualified), from a policy viewpoint, it would seem desirable to make sure this benefit is available to as many employees as possible.

[6] The Flexible Health Care Spending Account and Dependent Care Assistance Account Should be Treated as Reimbursement Accounts Rather Than Insurance

Congress originally intended that cafeteria plans enable employees to pick and choose among a variety of benefits rather than simply receive a group of company selected benefits, some of which were not needed or wanted by a particular employee. Some of these benefits come with tax advantages -- for instance, if an employee is willing either to reduce his salary or, if applicable, apply cafeteria dollars to a health FSA, then the dollars contributed to the health FSA are pre-tax dollars. In permitting this pre-tax treatment for flexible spending arrangements, the Service required an element of risk-shifting and risk-distribution inherent in an accident or health plan.[95] For employers, IRS imposed risk-shifting and risk-

[95] Prop. Treas. Reg. §1.125-2, Q&A 7, requires that health FSAs essentially qualify as accident or health plans and that, as a result, they must exhibit the risk-shifting and risk-distribution characteristics of insurance. To ensure that the health FSA includes risk-shifting and risk-distribution characteristics, this regulation requires

distribution characteristics by requiring uniform coverage throughout coverage period. The risk shifting feature imposed on the employee was the "use it or lose it" rule.[96]

By imposing the requirement of uniform coverage throughout the coverage period, the IRS intended to ensure that the employer would have an interest in regulating the arrangement "to minimize adverse selection and substantiate claimed expenses."[97] It is not clear how imposing this requirement would induce an employer to "minimize adverse selection." While an insurance carrier might decline to issue an insurance contract to an individual considered an excessive risk at any cost, application of this concept to the employment situation is too tenuous to be meaningful. Employment decisions simply are not based upon

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uniform coverage throughout the coverage period and a twelve-month period of coverage. Prop. Treas. Reg. §1.125-2, Q&A 7(a)(2). Treasury's concern, as expressed in the Preamble to these proposed regulations, was that absent these insurance-like features, a health plan whose premium was comparable to the maximum level of benefits would exclude from income amounts paid for personal medical expenses that otherwise would only be deductible under I.R.C. §213 to the extent they exceeded 7.5% of adjusted gross income. By introducing the requirement of uniform coverage throughout the coverage period, the IRS intended to ensure that the employer would have an interest in regulating the arrangement "to minimize adverse selection and substantiate claimed expenses." The IRS analyzed the arrangement as one in which the employee paid a premium for "health insurance" with respect to which the maximum reimbursement amount was the same or similar to the amount of the premium. IRS was trying to distinguish health FSAs from a simple health expense reimbursement account that would be akin to an employee-funded defined contribution plan.

As previously noted, however, health FSAs simply do not have the characteristics of insurance. With insurance, the purchaser of the contract pays a premium, gaining the potential of recovering from the insurance company benefits significantly in excess of premiums paid and risking that the purchaser will have no (or minimal) valid claims against the policy. Indeed, with most insurance contracts (e.g., car, fire, disability, umbrella), the purchaser would just as soon not incur any valid claims. The insurance company spreads its risks over a large number of contracts, "winning" on some and "losing" on others, but hoping to make a profit overall. With a health FSA, the employee simply cannot recover more than the amount contributed to the health FSA. Thus, characterizing salary reductions or employer contributions as premiums is inappropriate. There is no upside potential. Also, health FSAs do not involve the risk sharing characteristics of true insurance. The employer is not in the business of using a large number of health FSA accounts to spread the risk that any one employee might withdraw more benefits than the employee contributes to his or her health FSA account. Indeed, the employer is not looking to make a profit on the health FSA accounts but is simply offering a benefit to employees at minimal cost to the employer. The employer is not in the business of insuring or spreading risks. In other words, the analogy to insurance just does not work.

[96] This feature, unlike the "uniform service throughout the year" requirement, is also a feature of DCAPs.

[97] Preamble to Prop. Treas. Reg. §1.125-1 and 1-125-2, 54 Fed. Reg. 9460 (Mar. 7, 1989).

a risk that an employee might leave a position early in a plan year several years after first being hired by a company and thereby, incidentally, receive in health reimbursements more than the employee contributed to his or her health FSA in a particular year. The "use it or lose it" rule also imposes risk on the employee, but this risk certainly is not one typical of an insurance contract. It is difficult to imagine employees purchasing "insurance" when the most the employee can collect is 100% of the premium paid, and if one did not have claims up to that amount, then the remaining premium was forfeited. Rather, these rules imposing risk simply appear to be a way to stem the use of cafeteria plans and minimize the loss of revenue to the fisc from reduced FICA, FUTA and income taxes.

A more appropriate model for the health FSA or DCAP cafeteria plan is the 401(k) plan. Under this model, the health FSA or DCAP would function as a health expense reimbursement account, but the rules restricting the employees' ability to change the amount of deferrals and to select different or additional benefits would be removed. Thus, an employee would have the ability during the year, on a prospective basis, to change the amount of salary deferrals based on need rather than on an event mandated by the regulations.

[7] Cafeteria Plans Should Allow Employees to Change Their Benefit Elections on a Prospective Basis Throughout the Plan Year

Due to IRS regulations, employees are allowed to change their benefit elections during a plan year only under limited circumstances.[98] Because the dollars that the employees are applying towards various benefits are their own dollars (whether by salary reduction or by the application of cafeteria plan dollars), and more

[98] See §1.04, *supra*.

importantly, in order to encourage employees to elect needed benefits, employees should have the flexibility to change their benefit elections prospectively at reasonable, periodic intervals throughout the plan year. Just as defined contribution plans may allow employees to change their deferrals prospectively periodically during the plan year, so, too, should cafeteria plans be permitted to give employees flexibility to change their elections prospectively at more frequent intervals. This increased flexibility will make cafeteria plans more useful to employees in solving their health, dependent care and/or insurance needs. For example, in order to contain administrative costs, a company may decide that changes may be made only four times a year. This limitation should be set by the company for practical purposes, however, and should not be imposed by the government simply to impose a level of risk on the employee and discourage loss of revenues to the fisc.

[8] Limit Health FSAs to Specified Dollar Amount and Eliminate Risk Shifting to Employer

One rationale that the IRS used in imposing the uniform coverage rule on employers with respect to health FSAs was to ensure that employers bear certain risks comparable to an insurer's risk. This was intended to induce employers to monitor claims and limit the amount that employers would permit employees to contribute to health FSAs. Limiting the size of health FSAs could be more directly and rationally addressed simply by imposing an annual dollar limitation similar to that established for DCAPs. For instance, the limit could be $10,000, indexed for increases in the cost of living, with an additional $5,000 limit if the plan participant has more than one dependent or perhaps has certain types of health care problems which are generally not covered adequately by health insurance coverage (for instance, mental health care problems). *By applying a dollar limitation, the justification for placing employer dollars at risk, as described above, becomes unnecessary.* One could argue that by placing employer dollars

at risk in the health FSA, employers would voluntarily limit the dollar amounts that the employees can allocate to these accounts. A statutorily imposed limitation alleviates the need to have a limitation imposed by the companies.

[9] Eliminate the "Use it or Lose it" Rule

As discussed above, if an employee elects to have $5,000 of his compensation paid into a DCAP and then fails to use up the entire amount, the amount he did not use on dependent care is forfeited back to the employer. IRS regulations prohibit the company from giving the employee's money back to the employee directly or indirectly.[99] Employees are justifiably wary of this rule and may underestimate necessary health and dependent care assistance expenditures because they do not want to forfeit their own compensation back to their employers. Some companies have adopted policies that provide dollars forfeited by employees in one year will be applied to benefits or "cafeteria" dollars for all employees in the following year. While the intent of these companies is laudatory, this does not necessarily make the employee who lost a portion of his or her compensation any less upset to know that his or her compensation is providing benefits for all of the employees.

[a] *Options for Dollars Not Used by the Employee*

Rather than forcing employees to spend health care dollars on items they do not necessarily need in order to use up their health FSA dollars or providing that employees must forfeit unused dollars, the rules could be changed so that the total amount that an employee or employer could contribute in a single year to the employee's health FSA would be limited, but employeescould either "carry over" unused dollars

[99] Prop. Treas. Regs. §§1.125-1, Q&A 7, 15 and 18.

to the next year or sweepthem into a 401(k) plan (if available and if IRC §415 limitations have not been exceeded). In this manner, employees would not be allowed to exceed any of the cafeteria plan limitations regarding total annual contributions to a health FSA, but if needed, employees would be allowedto carry over unused contributions to subsequent years until the total amount was consumed.

A carryover would also provide a needed "cushion" for low and middle income taxpayers. As mentioned earlier, many lower income taxpayers cannot afford to reduce their salaries and wait for reimbursement at a later date; their cash flow is such that every dollar is needed immediately. Some employees cannot absorb in their budget even a two week delay. For these employees particularly, carrying over unused portions from one year to the nextwould provide them with the cash flow to be able to elect salary reductions in the second yearand reap the benefits of the tax-free treatment at the end of that year. This simple change would enablethese taxpayers to afford better quality child and/or elder care and to allow them to incur necessary medical expenses which are not covered by insurance.

§1.11 ADD LONG TERM CARE INSURANCE AS A QUALIFIED BENEFIT

Long term care insurance should bea qualified benefit which employers are able to make available to employees on a pre-tax basis under a cafeteria plan. As a matter of policy, employees should be encouraged to plan financially for the possible need forlong term care. For many employees, long term care insurance would be the vehicle of choice,

but the employees are unwilling to purchase this insurance on an after-tax basis using annual or quarterly premiums.

A cafeteria plan that allows employees to selecta long term care insurance plan (possibly tailoring it

to their needs with different levels of coverage and different price ranges) would assist employees in making an educated decision and would encourage wider coverage by making this employee benefit more affordable. Not only would the group price likely be lower than what each employee could obtain individually, but using pre-tax dollars to purchase the insurance would also make the insurance more affordable.

Making long term care insurance available on a pre-tax basis through payroll deduction (or in an employer dollar plan, through "cafeteria" plan dollars) may significantly increase the ability of NHCEs to plan for their future possible long term care needs. Premium conversion plans and 401(k) plans rely upon payroll deduction for their success. Based upon the success of the 401(k) plan, one can assume that employees who decide to finance their long term care through purchasing long term care insurance are more likely to purchase this insurance protection if they can finance the purchase through payroll deduction. Whether employees are more likely to select long term care insurance as a benefit choice when they do not have to find a plan on their own remains to be seen.

§1.12 MEDICAL SAVINGS ACCOUNTS COULD BE ADDED AS A QUALIFIED BENEFIT

To reduce the current cost of health insurance, some employees may choose to select a health care insurance option which has a larger deductible and self-insure the differential. Some health care experts believe that health insurance with higher deductibles would lead to cost efficiencies. The risk, of course, is that an employee elects a policy with a higher deductible in order to achieve the near term savings of lower premiums but fails to self-insure. If the employee fails to set aside sufficient funds to cover the deductible, then the employee may be unable to afford necessary health care procedures or tests. If as a result of not undertaking these procedures, emergency complications arise, the employee, by selecting the

policy with the higher deductible, may in effect simply be shifting his or her health care costs from the individual to society.

If offering health insurance with larger deductibles but lower premiums is an idea worthy of trying, then employees need a mechanism which would allow them to effectively self-insure up to the deductible. Allowing Medical Savings Accounts ("MSAs") to be an option under the cafeteria plan would be an ideal way to see if employees would choose toset aside funds for future health care costs if they could do this on a pre-tax basis. The Federal government could permit companies to offerMSAs and high deductible insurance coverage as a linked choice under a cafeteria plan, thereby affording employees another option.

§1.13 THE SIMPLIFIED SMALL BUSINESS CAFETERIA PLAN

Consideration should be given to providing small businesseswith a simplified cafeteria plan. The SIMPLE 401(k) plan is an appropriate model. This voluntary simplified plan design could provide reduced discrimination testing in exchange for simplified eligibility requirements and required employer contributions of cafeteria plan dollars. Similar to the SIMPLE 401(k) plan, the employer'srequired contribution could be a nonelective contribution of 2% of compensation for all NHCEs or possibly a 3% match ofNHCEs' salary reductions.[100]

[1] Change the Cafeteria Plan Eligibility Rules to Those of the 401(k) SIMPLE

Changing the cafeteria plan eligibility rules to those used in the 401(k) SIMPLE wouldallow employees to become eligible to participate in the cafeteria plan sooner than under the current rules. Currently,

[100] With a nonelective contribution, an issue arises as to the use of that contribution if the employee chooses not to participate in any of the benefits offered under the cafeteria plan. It would appear that a nonelective contribution safe harbor would have to be coupled with a cash out option. To encourage the employee to use the employer dollars to acquire benefits, the cash out option would probably have to provide the employee only a fraction of the employer's nonelective contribution.

employees generally must wait three years to become eligible to participate in a firm's cafeteria plan. If eligibility rules similar to those that apply to the SIMPLE 401(k) were used, then employees would have to attain age 21 and work 1000 hours a year to qualify, although employers could reduce either or both requirements. This change would increase the availability of cafeteria plan coverage to more small business employees. As in the SIMPLE 401(k) plan, small businesses would bring eligible employees in on an entry date for ease of administration. The plan could provide for two entry dates (or more, if the company desired). Again, as in the SIMPLE 401(k) plan, one entry date would coincide with the beginning of the plan year and the second would be the first day of the seventh month of the plan year.

[2] Streamline the Discrimination Tests Applicable to the Small Business Cafeteria Plan

The authors recommend that under a Simplified Small Business Cafeteria Plan only those discrimination tests applicable to an individual underlying plan benefit would be applied to that benefit, but the overarching discrimination tests imposed simply because various benefits are packaged together in a cafeteria plan would be eliminated. While the individual benefits would continue to be subject to the discrimination tests set forth in the IRC, the authors would hope that the dollar limitation and the discrimination tests applicable to DCAPs would be substantially changed so as to make this valuable benefit available to more employees. This is of particular importance because, as discussed in §1.06 [5], *supra*, many NHCEs select the tax credit, which causes the plan to fail the DCAP discrimination tests.

[3] Mandatory Employer Contribution

Just as safe harbors have been created to assist employers offering 401(k) plans to comply with discrimination requirements, so, too, the authors believe, safe harbors for satisfying discrimination standards

could be created to ensure fairness and adequate protection of employees, while sufficiently simplifying the administrative and cost burdens for small businesses and sufficiently increasing the likelihood that HCEs and keys will achieve favorable tax treatment in order to encourage small businesses to offer cafeteria plans.

For example, in order to qualify for the Simplified Small Business Cafeteria Plan, the company would be required to make a contribution on behalf of all eligible plan participants. This contribution could be similar to that required under the SIMPLE 401(k). Under the SIMPLE 401(k), the employer is required to match the employee's elective contribution on a dollar-for-dollar basis up to 3% of compensation for the plan year or to make nonelective contributions of 2% of compensation for each eligible employee, whether or not a particular employee elects, in addition, to authorize salary reductions. This employer nonelective contribution would be made for all eligible employees who have at least 1,000 hours of service during the plan year.[101] The employer also may substitute the 2% nonelective contribution for a matching contribution if eligible employees are notified of the substitution within a reasonable time prior to the period in which employees may enter salary reduction agreements.[102] Some companies might choose to require employees to allocate these dollars to health insurance coverage, if they were not already covered, but other employers might prefer to allow their employees to select the benefits they themselves deem most needed. From a policy viewpoint, both the nonelective contribution option and the match option have advantages. The match would hopefully provide an incentive for employees to make salary reduction

[101] For ease of administration, the safe harbor could employ a "look back" rule: if the employee had 1,000 hours in the prior year, he or she would be covered by the plan in the current year. In this manner, eligibility determinations could be made prior to the beginning of the plan year. This would be important in structuring qualifying employee elective deferrals.

[102] I.R.C. §401(k)(11)(B).

contributions to "purchase" the various needed benefits. On the other hand, the nonelective contribution would provide a contribution for all eligible employees so that the lower income taxpayers who cannot afford to reduce their salaries can still benefit.

§ 1.14 CONCLUSION

Cafeteria plans offer a flexible vehicle through which employees may select among a variety of benefits offered and in many cases use pre-tax dollars to acquire the benefits most useful to them. Whether funded with employee salary reduction dollars or employer cafeteria plan dollars, or a combination of both, the cafeteria plan provides a flexible private sector method for encouraging greater access to health care, dependent care, (hopefully, in the future, long term care insurance) and other benefits, inadequate access to which are considered significant public policy issues. Enabling employees to acquire these benefits using pre-tax dollars results in reduced income tax, FICA and FUTA revenues. Yet the increased ability of the private sector to provide these important benefits for workers and their families, rather than relying on the public sector to provide these benefits, may well justify the loss of revenues to the fisc.

Existing statutes and regulations, however, discourage small business from offering cafeteria plans to their employees. Antiquated limits on the value of dependent care assistance plans that may be offered to employees, multiple layers of discrimination testing on benefits and plans that are inherently not discriminatory, risk shifting requirements that are inapposite and discourage optimum use of benefits, regulations that exclude owners of many businesses from participating in cafeteria plans, exclusion of long-term care insurance and medical savings accounts as qualified benefits and limitations on employee's flexibility to change their elections prospectively within a plan year all converge to discourage small business from offering cafeteria plans and employees from taking maximum advantage of cafeteria plans that are offered.

The Simplified Small Business Cafeteria Plan may offer just the added incentive to encourage small businesses to offer critical benefits through a cafeteria plan umbrella. By reducing discrimination testing,

creating safe harbors using required employer contributions and simplifying eligibility requirements, a Simplified Small Business Cafeteria Plan, based largely on the SIMPLE 401(k) model, may enable a larger percentage of employers to make basic employee benefits available to workers and their families at an affordable cost and ensure that the choice to work with a small business will less frequently require employees to forego the tax-advantaged access to benefits formerly available to them under cafeteria plans.

Users/dac/Articles/NYU Cafeteria Plan (final)