

SUMMARY OF THE 2000 CAFETERIA PLAN REGULATIONS

What are the 2000 Cafeteria Plan Regulations?

These are regulations that were issued by the Internal Revenue Service in March, 2000. They affect certain aspects of cafeteria plans (also known as "flexible benefits plans" or "Section 125 plans"). The main purpose of the 2000 regulations is to clarify the rules about when cafeteria plan participants may change their benefit elections during a plan year.

- Some of the 2000 regulations are **final regulations**. These replace earlier temporary regulations that had been issued by the IRS in 1997. They are very similar to the earlier temporary regulations, but include some new clarifying language and examples. They also include several changes that generally make the rules more flexible.
- The remaining 2000 regulations are **proposed regulations**. These are also primarily concerned with the rules for mid-year election changes.

Copies of the both sets of regulations are enclosed.

When are the 2000 Regulations effective?

- The **final** regulations are applicable for cafeteria plan years beginning on or after January 1, 2001.
- The **proposed** regulations do not specify an effective date. However, the IRS has indicated that taxpayers may rely on them until further guidance is provided.

What changes did the **final** regulations make to the 1997 temporary regulations?

- The final regulations provide a new, more flexible rule regarding mid-year election changes permitted due to employment status changes. (See below.)
- The final regulations permit an employee to elect either to increase or decrease group term life insurance coverage provided through the cafeteria plan if there is a change in the employee's marital status or in the employment status of his or her spouse or dependent. The same rule applies to disability income benefits provided through cafeteria plans.
- The final regulations clarify that if an employee, spouse, or new dependent is entitled, due to a special enrollment period required under HIPAA*, to enroll in the group health plan included in the employer's cafeteria plan, the cafeteria plan may also permit the employee to enroll any other existing dependents in the group health plan.
- The final regulations similarly clarify that existing family members can be added if the employee becomes entitled to elect family coverage under a group health plan

provided through the cafeteria plan due to a status change involving a new spouse or dependent.

- The final regulations clarify that, if Medicare or Medicaid entitlement is lost by an employee, spouse, or dependent, the cafeteria plan may allow the employee to elect coverage under the group health plan provided through the cafeteria plan. The plan may also permit cancellation or reduction in coverage if an employee, spouse, or dependent enrolled in the group health plan becomes entitled to Medicare or Medicaid.

What is the new rule regarding changes in employment status?

Under the new rule, an employee is permitted to change his or her cafeteria plan elections whenever:

- there is a change in the employee's employment status that affects his or her eligibility under the cafeteria plan;
- there is a change in the employment status of the employee's spouse that affects the spouse's eligibility under a cafeteria plan or a qualified benefits plan; or
- there is a change in the employment status of the employee's dependent that affects the dependent's eligibility under a cafeteria plan or a qualified benefits plan.

Changes in employment status include a termination or commencement of employment, a strike or lockout, a commencement of or return from an unpaid leave of absence, and a change in worksite.

What do the 2000 *proposed* regulations address?

The proposed regulations address:

- mid-year cafeteria plan election changes for dependent care assistance and adoption assistance plans provided through cafeteria plans.
- an expansion of the rules regarding mid-year election changes that are allowed due to changes in cost or coverage.

What are the proposed rules for dependent care assistance and adoption assistance election changes?

The election change rules for these benefits largely parallel those for health benefits and group-term life insurance. There are also some additional rules specific to these benefits.

- A change in the number of "qualifying individuals" (dependents for whose care eligible dependent care expenses may be incurred) is considered a change in status permitting a mid-year election change for a dependent care assistance

component of a cafeteria plan.

- The commencement or termination of adoption proceedings are considered a change in status permitting a mid-year election change for an adoption assistance component of a cafeteria plan.
- Mid-year election changes must be consistent with the eligible status change that has occurred. For a dependent care assistance plan, this means the election change must be on account of and must correspond with a change in status that affects eligible dependent care expenses as defined in the IRS Code. For an adoption assistance plan, the change must be on account of and must correspond with a change in status that affects qualified adoption expenses as defined in the IRS Code.

How are the cost or coverage change rules affected?

The proposed regulations provide that:

- If a plan adds a new benefit package option (such as a new HMO option), the cafeteria plan may permit affected participants to elect that option and make a corresponding mid-year election change with respect to other options.
- the election change rules are expanded to include changes in the cost of self-funded health plans, group-term life insurance, dependent care assistance, and adoption assistance coverage rather than only the cost of group health insurance. Therefore, if the cost of a self-funded health plan increases, the plan may provide for an automatic corresponding adjustment in the participants' salary reduction contributions.
- a change of dependent care provider is treated as analogous to the addition of a new HMO option under a health plan. A corresponding election change can be made when one dependent care provider is replaced by another. See the example given in the proposed regulations (enclosed) at 1.125-4(f)(5), Example 5 for an illustration of the way a change in dependent care providers is treated.
- the cost-change rules do not apply to dependent care if the provider of services is a relative of the employee making the election.
- a cafeteria plan may permit an employee to make a mid-year election change if the employee's spouse changes his or her cafeteria plan elections during an annual open enrollment period for the spouse's employer's plan. This would occur when the cafeteria plan of the spouse operates on a different plan year than the plan year of the employee's cafeteria plan.
- a cafeteria plan may permit an employee to make a mid-year election change if his or her spouse or dependent makes an allowable election change under the spouse's or dependent's cafeteria plan. The change must be on account of and must correspond with the change under the other cafeteria plan.
- the cost or coverage rules in the proposed regulations do *not* extend to health

care flexible spending account (FSA) plans. This is done so that the FSA plans will continue to exhibit the required risk-shifting and risk-distribution characteristics of health insurance.

Under the new and existing regulations, when may an employee who is eligible to participate in a cafeteria plan change his or her elections during a plan year?

Employees may not change or revoke their elections during the plan year except in accordance with those of the following rules that have been elected for inclusion in the cafeteria plan by the employer.

1. **Mid-Year Election Changes Due to HIPAA Special Enrollment Rights.** An eligible employee who becomes covered, or whose spouse or dependent becomes covered, under the employer's group health plan during a "special enrollment period" required by the Health Insurance Portability and Accountability Act ("HIPAA") may prospectively make a corresponding change in his or her cafeteria plan elections with respect to the group health plan benefits provided through the cafeteria plan.

Under HIPAA, special enrollment periods are generally allowed due to certain losses of other group health coverage and changes in family status. A special enrollment period is allowed due to a loss of other group health coverage if the eligible employee:

- declined coverage under the employer's group health plan when he or she first became eligible for it;
- stated in writing that coverage was declined due to the existence of other group (or COBRA) coverage;
- has lost the other group coverage and has requested enrollment in the employer's group health plan within 30 days thereafter.

A special enrollment period is allowed due to a change in family status if an eligible employee who is eligible for coverage under the employer's health plan has gained a dependent through:

- marriage;
- birth;
- adoption; or
- placement for adoption.

2. **Mid-Year Election Changes Due to Eligible Status Changes.** An eligible employee who experiences an eligible status change may prospectively change his or her previous elections by revoking or modifying them in a manner that is consistent (as

described below) with the status change. Eligible status changes include only changes in an individual's eligibility status with respect to an employer-sponsored qualified benefit plan due to at least one of the following events:

- a change in the eligible employee's legal marital status through marriage, the death of the employee's spouse, divorce, legal separation, or annulment.
- a change in the number of the employee's dependents for federal income tax purposes through birth, adoption, placement for adoption, or the death of a dependent.
- the beginning or termination of employment of the employee or his or her spouse or dependent.
- a reduction or increase in the working hours of the employee or his or her spouse or dependent, including work-hour changes resulting from a switch between part-time and full-time employment, strike, lockout, or the beginning or end of an unpaid leave of absence.
- the employee's dependent satisfying or ceasing to satisfy the requirements for eligibility (for example, by attaining the limiting age or by losing full-time student status).
- a change in the workplace or residence of the employee, his or her spouse, or his or her dependent.

3. **Consistency of Election Changes with Eligible Status Changes.** An election change made due to an eligible status change is permitted only where the election change is related to and corresponds with the particular change that has occurred.

- A plan participant may not cancel coverage for an individual who has become eligible for coverage under another plan due to an eligible status change unless the individual actually becomes covered under the other plan.
- An election change in group term life insurance benefits or disability income insurance benefits due to a change in marital status must correspond to a resulting need to satisfy a coverage deficiency or to eliminate unnecessary coverage.
- A plan participant may make an election change in his or her dependent care assistance benefits if an eligible status change affects his or her qualified employment-related dependent care expenses under Internal Revenue Code Section 129.
- A plan participant may make an election change in his or her qualified adoption assistance benefits if an eligible status change affects his or her qualified adoption expenses under Internal Revenue Code Section 137.

Despite the consistency rule, however:

- An employee who, due to an eligible status change, is permitted within the rule to add coverage under group health plan benefits for a spouse or dependent child(ren), may, at the same time, also add group health plan benefits coverage for his or her other eligible family members.
- A plan participant who has elected group term life insurance benefits and who experiences an eligible status change consisting of a change in employment status or marital status is permitted to increase or decrease his or her group term life insurance benefits (subject to the applicable provisions of the employer's group term life insurance policy), regardless of whether the eligible status change causes a loss or gain of eligibility.

4. **Mid-Year Election Changes Due to Entitlement to COBRA.** An Eligible Employee who becomes entitled to continued group health plan coverage under COBRA or under a state-mandated continuation of group health plan coverage, or whose spouse or dependent becomes so entitled, may change his or her cafeteria plan elections with respect to health benefits.

5. **Mid-Year Election Changes Due to a QMCSO.** An eligible employee who is required to provide health coverage to his or her children by a QMCSO issued due to a divorce, legal separation, annulment or change in legal custody may change his or her cafeteria plan elections with respect to group health plan benefits.

6. **Mid-Year Election Changes Due to Changes in Medicare and Medicaid Entitlement.** An eligible employee who becomes entitled to or ceases to be entitled to Medicare or Medicaid, or whose spouse or dependent does so, may change his or her cafeteria plan elections with respect to health benefits.

7. **Mid-Year Election Changes Due to Eligible Changes in Coverage under the Plan.** If coverage under any benefit provided through the cafeteria plan is significantly curtailed or terminated during the plan year, an affected eligible employee may make an election change to elect another option providing similar coverage, if one is available under the plan. Coverage under group health plan benefits are considered to be "significantly curtailed" only if there is an overall reduction in coverage that affects all covered participants. In the event benefits are significantly curtailed and no alternative option is available under the plan, revocation of the election is permitted.

If benefits are added to or eliminated from the cafeteria plan during the plan year, affected eligible employees may make an election change to elect the new benefits or replace the eliminated benefits with another benefit (other than health care flexible spending account benefits) providing similar coverage, if one is available under the Plan. A change in dependent care providers is deemed analogous to the addition of a new benefit option to the plan, and thus justifies a mid-year election change.

8. **Mid-Year Election Changes Due to Eligible Changes in Coverage under a Family Member's Plan.** An eligible employee may make a prospective election change

due to and consistent with a change in coverage under the Code Section 125 cafeteria plan sponsored by the employee's spouse, former spouse, or dependent, when the change in coverage results from either: (1) an election change permitted under that cafeteria plan due to an eligible status change or an eligible change in coverage; or (2) an election change made during that cafeteria plan's annual open enrollment period, where its plan year does not coincide with the plan year of the employee's plan.

9. **Mid-Year Election Changes Due to Changes in Coverage Costs.** If the cost that is charged to all participants for a benefit is significantly increased during the plan year, each affected participant may prospectively change his or her election to elect another benefit option providing similar coverage, if such an option is available under the cafeteria plan. If no such alternative option is available, revocation of the election is permitted.

10. **Mid-Year Election Changes Due to Commencement or Termination of Adoption Proceedings.** With respect to elections of qualified adoption assistance benefits only, an eligible employee may change his or her election due to the commencement or termination of an adoption proceeding.

11. **Mid-Year Election Changes in Dependent Care Assistance Benefits Due to Changes in Dependent Care Expenses.** An eligible employee may change his or her election with respect to dependent care assistance benefits, if included in the cafeteria plan, due to a cost change imposed by the employee's dependent care provider, unless that provider is the employee's relative. For purposes of this provision, "relative" means a person who is related as described in Internal Revenue Code Section 152.

IRS FINAL REGULATIONS (T.D. 8878) ON TAX TREATMENT OF CAFETERIA PLANS

Reg § 1.125-4. Permitted election changes.

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

(b) Special enrollment rights.

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

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

Example (1)

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

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

Example (2)

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

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

(c) Changes in status.

(1) In general.

(i) Change in status rule. A cafeteria plan may permit an employee to revoke an

election during a period of coverage with respect to a qualified benefits plan to which this paragraph (c) applies and make a new election for the remaining portion of the period (referred to in this section as an election change) if, under the facts and circumstances –

- (A) A change in status described in paragraph (c)(2) of this section occurs; and
- (B) The election change satisfies the consistency rule of paragraph (c)(3) of this section.

(ii) Application to accident or health plans and group-term life insurance plans. This paragraph (c) applies to plans providing accident or health coverage and plans providing group-term life insurance coverage.

(iii) Application to other qualified benefits. [Reserved]

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

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

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

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

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

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

(3) *Consistency rule.*

(i) Application to accident or health coverage and group-term life insurance. An

election change satisfies the requirements of this paragraph (c)(3) with respect to accident or health coverage or group-term life insurance only if the election change is on account of and corresponds with a change in status that affects eligibility for coverage under an employer's plan.

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

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

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

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

Example (1)

(i) Employer M provides health coverage (including a health FSA) for its employees through its cafeteria plan. Before the beginning of the calendar year, Employee A elects employee-only health coverage under M's cafeteria plan and elects salary reduction contributions to fund coverage under the health FSA. Employee A marries B during the year. Employee B's employer, N, offers health

coverage to N's employees (but not including any health FSA), and, prior to the marriage, B had elected employee-only coverage. Employee A wants to revoke the election for employee-only coverage, and is considering electing family health coverage under M's plan or obtaining family health coverage under N's plan.

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

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

Example (2)

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

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

Example (3)

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

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

correspond with the change in status, and thus the cafeteria plan may permit E to elect employee-plus-one-dependent health coverage.

Example (4)

- (i) Employer R maintains a calendar year cafeteria plan under which full-time employees may elect coverage under one of three benefit package options provided under an accident or health plan: an indemnity option or either of two HMO options for employees who work in the respective service areas of the two HMOs. Employee A, who works in the service area of HMO #1, elects the HMO #1 option. During the year, A is transferred to another work location which is outside the HMO #1 service area and inside the HMO #2 service area.
- (ii) The transfer is a change in status under paragraph (c)(2)(iii) of this section (relating to a change in worksite), and, under the consistency rule in paragraph (c)(3) of this section, the cafeteria plan may permit A to make an election change to either the indemnity option or HMO #2.

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Example (5)

- (i) Employer S maintains a calendar year cafeteria plan that allows employees to elect coverage under an accident or health plan providing indemnity coverage and coverage under a health FSA. Prior to the beginning of the calendar year, Employee B elects employee-only indemnity coverage, and elects salary reduction contributions of \$600 during the year to fund coverage under the health FSA for up to \$600 of reimbursements for the year. Employee B's spouse, C, has employee-only coverage under an accident or health plan maintained by C's employer. During the year, C terminates employment and loses coverage under that plan. B now wants to elect family coverage under S's accident or health plan and increase B's FSA election.
- (ii) C's termination of employment is a change in status under paragraph (c)(2)(iii) of this section, and the election change satisfies the consistency rule of paragraph (c)(3) of this section. Therefore, the cafeteria plan may permit B to elect family coverage under S's accident or health plan and to increase B's FSA coverage.

Example (6)

- (i) Employer T provides group-term life insurance coverage as described under section 79. Under T's plan, an employee may elect life insurance coverage in an amount up to \$50,000. T also maintains a calendar year cafeteria plan under which qualified benefits, including the group-term life insurance coverage, are funded through salary reduction. Employee D has a spouse and a child. Before the beginning of the year, D elects \$10,000 of group-term life insurance coverage. During the year, D is divorced.
- (ii) The divorce is a change in status under paragraph (c)(2)(i) of this section. Under

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

Example (7)

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

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

Example (8)

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

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

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

(iv) If, instead, H terminates employment and cancels coverage during a period of unemployment, and then returns to work more than 30 days following termination of

employment, the cafeteria plan may permit H the option of returning to the election in effect prior to termination of employment or making a new election under the plan. Alternatively, the cafeteria plan may prohibit H from returning to the plan during that plan year.

(d) Judgment, decree, or order.

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

- (i) Changes the employee's election to provide coverage for the child if the order requires coverage for the child under the employee's plan; or
- (ii) Permits the employee to make an election change to cancel coverage for the child if the order requires the spouse, former spouse, or other individual to provide coverage for the child.

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

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

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

election to commence or increase coverage of that employee, spouse, or dependent under the accident or health plan.

(f) Significant cost or coverage changes. [Reserved]

(g) Special requirements relating to the Family and Medical Leave Act. An employee taking leave under the Family and Medical Leave Act (FMLA) (Public Law 102-530 (88 Stat. 829)) may revoke an existing election of group health plan coverage and make such other election for the remaining portion of the period of coverage as may be provided for under the FMLA.

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

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

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

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

(3) Dependent. A dependent means a dependent as defined in section 152, except that, for purposes of accident or health coverage, any child to whom section 152(e) applies is treated as a dependent of both parents.

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

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

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

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

(8) Qualified benefits plan. A qualified benefits plan means an employee benefit plan governing the provision of one or more benefits that are qualified benefits under

section 125(f).

(j) Effective date. This section is applicable for cafeteria plan years beginning on or after January 1, 2001.

T.D. 8878, 3/22/2000.

IRS PROPOSED RULEMAKING (REG-117162-99) ON TAX TREATMENT OF CAFETERIA PLANS

PAR. 2 In §1.125-1, as proposed to be added on May 7, 1984 (49 FR 19322), in Q&A-8, Q-8 is republished and A-8 is amended by adding two sentences at the end of the answer to read as follows:

Proposed Amendment 1.125-1. Questions and answers relating to cafeteria plans.

Q- 8. What requirements apply to participants' elections under a cafeteria plan?

A- 8. ***For benefit elections relating to accident or health plans and group-term life insurance coverage, a cafeteria plan may permit a participant to revoke a benefit election after the period of coverage has commenced and to make a new election with respect to the remainder of the period of coverage under the rules set forth in §1.125-4 pertaining to permitted election changes. For additional rules governing benefit elections, see §1.125-4.

PAR. 3 In §1.125-2, as proposed to be added on March 7, 1989 (54 FR 9500) and amended November 7, 1997 (62 FR 60197), in Q&A-6, Q-6 is republished and A-6 is amended by:

1. Adding a sentence at the end of paragraph (b)(2).
2. Revising the last sentence of paragraph (c).
3. Revising the last sentence of paragraph (d).

The additions and revisions read as follows:

Proposed Amendment 1.125-2. Miscellaneous cafeteria plan questions and answers.

Q- 6. In what circumstance may participants revoke existing elections and make new elections under a cafeteria plan?

A- 6. ***

(b) ***

- (2) ***For additional rules governing cafeteria plan election changes in

connection with a significant cost or coverage change, see §1.125-4.

(c) Certain changes in family status. ***For additional rules governing cafeteria plan election changes in connection with certain changes in status, see §1.125-4.

(d) Separation from service. ***For additional rules governing cafeteria plan election changes in connection with an employee's separation from service, see §1.125-4.

PAR. 4 Sec. 1.125-4 is amended as follows:

1. Paragraph (c) is amended as follows:
 - a. Revising paragraph (c)(1)(iii).
 - b. Adding paragraph (c)(2)(vi).
 - c. Revising paragraph (c)(3)(ii).
 - d. Adding paragraphs (c)(4)Example 3(iii) and (c)(4)Example 9.
2. Revising paragraph (f).
3. Revising paragraph (g).
4. Revising paragraph (i)(3).

The additions and revisions read as follows:

Proposed Amendment 1.125-4. Permitted election changes.

(c) ***

(1) ***

(iii) Application to other qualified benefits. This paragraph (c) applies to plans providing qualified benefits other than those listed in paragraph (c)(1)(ii) of this section.

(2) ***

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

(3) ***

(ii) Application to other qualified benefits. An election change satisfies the requirements of this paragraph (c)(3) with respect to other qualified benefits if the election change is on account of and corresponds with a change in status that affects eligibility for coverage under an employer's plan. An election change also satisfies the requirements of this paragraph (c)(3) if the election change is on account of and corresponds with a change in status that affects expenses described in section 129 (including employment-related expenses as defined in section 21(b)(2)) with respect to dependent care assistance, or expenses described in section 137 (including qualified adoption expenses as defined in section 137(d)) with

respect to adoption assistance.

(4) ***

Example (3) ***

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

Example (9)

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

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

(f) Significant cost or coverage changes.

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

(2) *Cost changes.*

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

(ii) *Significant cost increases.* If the cost of a benefit package option (as defined in paragraph (i)(2) of this section) significantly increases during a period of coverage, the cafeteria plan may permit employees either to make a corresponding prospective increase in their payments, or to revoke their elections and, in lieu thereof, to receive on a prospective basis coverage under another benefit package option providing similar coverage. For example, if the cost of an indemnity option under an accident or health plan significantly increases during a period of coverage, employees who

are covered by the indemnity option may make a corresponding prospective increase in their payments or may instead elect to revoke their election for the indemnity option and, in lieu thereof, elect coverage under an HMO option.

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

(3) Coverage changes.

(i) Significant curtailment. If the coverage under a plan is significantly curtailed or ceases during a period of coverage, the cafeteria plan may permit affected employees to revoke their elections under the plan. In that case, each affected employee may make a new election on a prospective basis for coverage under another benefit package option providing similar coverage. Coverage under an accident or health plan is significantly curtailed only if there is an overall reduction in coverage provided to participants under the plan so as to constitute reduced coverage to participants generally.

(ii) Addition (or elimination) of benefit package option providing similar coverage. If during a period of coverage a plan adds a new benefit package option or other coverage option (or eliminates an existing benefit package option or other coverage option) the cafeteria plan may permit affected employees to elect the newly-added option (or elect another option if an option has been eliminated) prospectively on a pre-tax basis and make corresponding election changes with respect to other benefit package options providing similar coverage.

(4) Change in coverage of spouse or dependent under other employer's plan. A cafeteria plan may permit an employee to make a prospective election change that is on account of and corresponds with a change made under the plan of the spouse's, former spouse's or dependent's employer if –

(i) A cafeteria plan or qualified benefits plan of the spouse's, former spouse's, or dependent's employer permits participants to make an election change that would be permitted under paragraphs (b) through (g) of this section (disregarding this paragraph (f)(4)); or

(ii) The cafeteria plan permits participants to make an election for a period of coverage that is different from the period of coverage under the cafeteria plan or qualified benefits plan of the spouse's, former spouse's, or dependent's employer.

(5) Examples. The following examples illustrate the application of this paragraph (f):

Example (1)

(i) A calendar year cafeteria plan is maintained pursuant to a collective bargaining agreement for the benefit of Employer M's employees. The cafeteria plan offers various benefits, including indemnity health insurance and a health FSA. As a result of mid-year negotiations, premiums for the indemnity health insurance are reduced

in the middle of the year, insurance co-payments for office visits are reduced under the indemnity plan, and an HMO option is added.

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

(iii) Also, the addition of the HMO option is an addition of a benefit package option. Accordingly, under paragraph (f)(3)(ii) of this section, the cafeteria plan may permit affected participants to make an election change to elect the new HMO option. However, the plan may not permit employees to change their health FSA elections to reflect differences in copayments under the HMO option.

Example (2)

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

(ii) Under paragraph (f)(4)(ii) of this section, N's cafeteria plan may permit A to change A's election prospectively to family coverage under that plan effective September 1, 2001 if B actually elects no coverage under O's group health plan for the plan year beginning on September 1, 2001.

Example (3)

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

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

Example (4)

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

(ii) E's change from the HMO to indemnity plan is not a change in cost or coverage under this paragraph (f), and none of the other election change rules under paragraphs (b) through (e) of this section apply. While R's health plan may permit E to make the change from the HMO to the indemnity plan, R's cafeteria plan may not permit E to make an election change to reflect the increased premium. Accordingly, if E switches from the HMO to the indemnity plan, E may pay the \$40 per month additional cost on an after-tax basis.

Example (5)

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

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

Example (6)

(i) Employee D is married to Employee E and they have one child, F. Employee D's employer, N, maintains a calendar year cafeteria plan that allows employees to elect coverage under a dependent care FSA. Child F is cared for by Y, D's household employee, who provides child care services five days a week from 9 a.m. to 6 p.m. at an annual cost in excess of \$5,000. Prior to the beginning of the year, D elects salary

reduction contributions of \$5,000 during the year to fund coverage under the dependent care FSA for up to \$5,000 of reimbursements for the year. During the year, F begins school and, as a result, Y's regular hours of work are changed to five days a week from 3 p.m. to 6 p.m. Employee D now wants to revoke D's election under the dependent care FSA, and make a new election under the dependent care FSA to an annual cost of \$4,000 to reflect a reduced cost of child care due to Y's reduced hours.

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

Example (7)

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

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

(g) Special requirements relating to the Family and Medical Leave Act.
[Reserved]

(i) ***

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

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

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