McGraw Wentworth

BENEFIT Advisor

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In This Issue

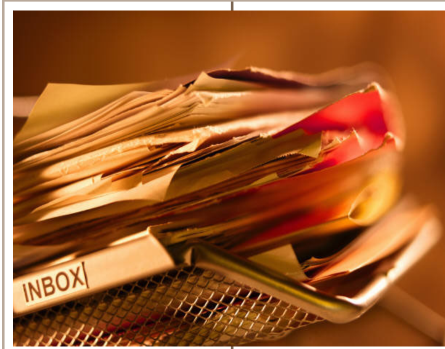
In this issue of the McGraw Wentworth Benefit Advisor, we will review the new and proposed regulations for mid-year elections for cafeterial plans issued by the IRS on 3/23/00 for plan years beginning on or after 1/1/01. We will review the final regulations and, specifically, the change events outlined in the final regulations. We will also outline the proposed regulations and how they coordinate with the final regulations. Lastly, we will review the effect the proposed and final regulations will have on your plan going forward.

We welcome your comments and suggestions regarding this issue of our technical bulletin. For more information on this Benefit Advisor, please contact your Account Manager or visit the McGraw Wentworth web site at www.mcgrawwentworth.com.

"New Final & Proposed Regulations"

For Mid Year Elections For Cafeteria Plans

On March 23, 2000, the IRS issued final and proposed regulations concerning mid-year elections for cafeteria plans. The final regulations go into effect for plan years beginning on or after January 1, 2001. Until that time, employers may rely on the final, new proposed or previously proposed regulations. The new regulations provide for clearer guidance and greater administrative flexibility when it comes to mid-year election changes.



Final Regulations

The final regulations provide a detailed list of what events trigger a permissible mid-year change in an employee's election of cafeteria plan benefits. Unlike the regulations proposed in 1989, the "change events" listed in these final regulations are "exclusive." No other events will allow an employee to change benefit selections mid-year. Under the prior regulations, the list of events that allowed for new elections was not exclusive, rather the listed events were just examples, and it was not clear what other events might be similar enough to those listed to allow for a mid-year election change. In this way, the final regulations provide clearer guidance. The final regulations also clarify that cafeteria plans do not have to allow all or any of the listed events to trigger mid-year changes. Only those events set forth in the regulations and that are listed in the plan document will permit mid-year cafeteria plan elections.

Change Events

The change events listed in the final regulations are:

1. ***Change In Status Events.***

- ***Change of Residence.*** *If the employee, spouse and/or dependent has changed residence, thus moving from one service area to another, they may change coverages necessitated by the change of residence, but cannot drop coverage altogether for this reason.*
- ***Change in Employment Status.*** *Changes in the employment status of an employee, spouse or a*

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dependent which results in eligibility or ineligibility under an employer's plan, including the:

- ⇨ *gain or loss of employment*
- ⇨ *change from part-time to full-time status (or vice-versa)*
- ⇨ *change from salaried to hourly (or vice-versa)*
- ⇨ *switch from union to nonunion status (or vice-versa)*
- ⇨ *return from unpaid leave of absence*
- ⇨ *a strike or lockout*

- ***Change in Number of Dependents****. Increase or decrease in number of tax dependents on account of birth, death, adoption, and placement for adoption.*
- ***Change in Legal Marital Status****. Changes in coverage requirements on account of marriage, death of spouse, divorce, legal separation, or annulment.*
- ***Dependent Satisfying or Failing to Satisfy Eligibility Requirements****. For example, a dependent ceases to qualify as a covered dependent because he or she attained the age of majority under the Plan, is no longer entitled to benefits as a full-time student or becomes too old for caretaker payment to qualify as an eligible dependent care expense.*

Under the final regulations, these status change events apply to health care and life insurance coverage, but the proposed rules (*see below*) extend them to all qualified benefits offered under a cafeteria plan. In addition, these "status change events" must be applied according to a consistency rule which says that any change in benefit elections must be consistent with the status change event which occurred.

Consistency Rule. The final regulations did not change the consistency rules found in the prior proposed and temporary regulations, but they did spell out in greater detail what election changes are consistent with the status change events. For example, if the status event is the death of a spouse or dependent, the corresponding change can only be to drop the deceased from coverage. There is no option to drop coverage for oneself or other dependents who are still living and are covered by the plan. Similarly, if the status event relates to a divorce, annulment or legal separation, the only coverage that can be dropped is coverage for the spouse involved in the divorce, annulment or legal separation. While the consistency rule appears to limit the participant's range of choices, taken together, the consistency rules will likely allow the needed flexibility. For example, a divorce would only allow coverage to be dropped for the ex-spouse, but if the ex-spouse becomes employed following the divorce and becomes entitled to benefits under his or her new employer's plan, then the couple's dependents may be allowed to be dropped from the employee's plan and enrolled in the ex-spouse's plan. The change is allowed on account of the spouse's new employment status change event and not on account of the divorce or legal separation. Thus, the regulations allow for flexibility, but care must be taken in how they are administered. With respect to life and disability insurance, the consistency rule expressly allows that either an increase or decrease in coverage may correspond to a given status change event.

2. ***COBRA****. COBRA is another change event and is characterized in the final regulations as an exception to the consistency rule. An election change is allowed if a qualifying event occurs where the employee is required to pay COBRA premiums. Since the employee must be receiving compensation to be able to take advantage of any cafeteria plan benefit, this change event likely applies where the qualifying event is a divorce or legal separation and the employee wishes or needs to pay COBRA premiums for his or her ex-spouse. The final regulations permit this to be done on a pre-tax basis. This is an exception to the consistency rule because although a "dependent" is being dropped from coverage, the employee is allowed to increase the amount deducted to pay for the new COBRA qualified beneficiary.*

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Notable Thoughts

You must first have a lot of patience to learn to have patience.

Stanislaw J. Lec

3. ***Domestic Relations Order or Qualified Medical Child Support Order.*** *When a divorce, legal separation, annulment or change in legal custody occurs, cafeteria plan changes are permitted to conform with the domestic relations judgment, decree, or order or qualified medical child support order. If one spouse is providing coverage, but the other is ordered to provide the coverage, the spouse currently providing coverage may drop the dependents he or she is covering and the spouse ordered to provide coverage may add the dependents. Coverage may be added or deleted pursuant to the terms of the order.*

4. ***Family and Medical Leave Act (FMLA).*** *An employee taking a FMLA-qualified leave may revoke an existing election and make another election for the remainder of the coverage period as permitted by FMLA.*

5. ***Health Insurance Portability and Accountability Act ("HIPAA").*** *Circumstances that allow for special enrollment rights under HIPAA are permissible change events. The election changes are to be effective as allowed under HIPAA, which means certain changes may be permitted retroactively. This is the only scenario where retroactive election changes are permissible (due to birth, adoption, or placement for adoption).*

6. ***Medicare/Medicaid.*** *Medicare or Medicaid entitlement or loss of Medicare and Medicaid entitlement are change events permitting mid-year coverage changes. Entitlement to such coverage allows a participant to elect to reduce coverage under the employer's plan while loss of such coverage will allow him or her to elect or increase such coverage.*

Special Rule: Rehire Within 30 Days Safe Harbor. When an employee is terminated, but rehired within 30 days, that employee may reinstate the same election options he or she had prior to termination. For premium conversion benefits, they may select the same benefit options and reinstate the same salary reduction amounts. For health care flexible spending accounts ("FSAs"), he or she will again reinstate the salary reduction amounts and have access to their full annual election (less prior reimbursements). The employee will not be required to make up the salary reductions missed during the absence, but neither will the employee be eligible for reimbursement of expenses incurred during the period he or she was terminated from work. This provides a "safe harbor" for allowing returning employees to "pick up where they left off," so to speak, without jeopardizing the plan's tax benefits. This safe harbor provision must, however, be included in the plan document and SPD to be effective.

If the employee returns to work within the same plan year, but more than 30 days after termination, the cafeteria plan may permit the employee to reinstate their original election, allow the employee to make a new election, or choose to make the employee wait until the next open enrollment period to return to the plan. The option(s) which the plan provides must also be spelled out in the document.

Proposed Regulations

Until they become effective (and no effective date has yet been determined), the new proposed or previously proposed regulations may be relied upon. As noted above, the new proposed regulations apply the status change events, not only to health and life insurance coverages, but to all qualified cafeteria plan benefits. The new proposed regulations also clarify when mid-year elections may be made on account of plan cost and coverage changes and in doing so, fill in some areas not addressed in the final regulations.

1. ***Changes in Cost.*** *If the cost of a plan benefit increases or decreases and the employees are required to make a corresponding change in their plan contributions, these changes can be made automatically. When there is a "significant" increase in cost*

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Fun Fact

No matter where you stand in Michigan, you are never more than 85 miles from a Great Lake.

with respect to a benefit option package, the plan may either allow employees to make an increase to their contributions or to revoke their elections and elect different coverage under the same or a similar plan. For example, if the cost of an indemnity plan goes up drastically during the course of the plan year, the covered employee has the option to increase his or her contribution to the plan or revoke the election and enroll in the HMO plan instead. The regulations, however, do not define "significant" in this context so some uncertainty about the application of this provision remains. In addition, your carriers must agree to allow a special open enrollment period under these circumstances.

The proposed regulations, however, do not change other cafeteria plan rules, with the result that these changes in cost provisions do not apply to health FSAs. While a participant cannot change his or her health FSA election to cover increased premium costs, they can, however, use their premium conversion account to pay for the increase in premiums. The cost changes do apply to dependent care FSAs, so long as the cost change is not imposed by a dependent care provider who is a relative of the employee (as defined in the Tax Code).

2. ***Changes in Coverage**. Mid-year changes are permitted in the case of significant changes in coverage (i.e., coverage is curtailed or increased). Coverage is considered significantly curtailed only if there is a reduction in overall coverage under the plan. For example, if a physician leaves a provider network, it would not be considered an opportunity for employees to make a change, but if a new HMO option were added mid-year, employees would likely be allowed to elect this new coverage option. The physician's departure would not signify a "significant reduction in coverage." Elections may also be revised if a benefit option package is added or eliminated mid-year. In addition, like the adjustments made to the changes in cost rule, the changes in coverage rule is expanded to all qualified benefits, except for health FSA elections. This means that new dependent care elections can be made to reflect a change in dependent care providers.*

3. ***Change in Coverage Under Other Employer's Plan.** Employees may make election changes mid-year if there is a corresponding open enrollment change made by a spouse or a dependent whose plan year is different from that of the employee. In this case, the employee's election must correspond with the election made by the spouse or dependent. In addition, employees may make election changes mid-year, other than in their health FSA accounts, if there is a mid-year change in coverage offered under the spouse's or dependent's plan. For example, if a spouse's plan begins to offer orthodontia coverage and the employee elects to drop his or her dependents from his or her dental coverage and enroll the dependents in the spouse's plan due to the addition of the orthodontia benefit, the change is permissible. However, dropping the dependents from coverage does not permit the employee to make a change to his or her health FSA election. The purpose of this proposed regulation is for employees to avoid overlaps and gaps in coverage due to differing plan years.*

4. ***Dependent Care Change in Status.** The proposed regulations do not create special changes for dependent care FSAs, but clarify that changes in cost and coverage permit changes to dependent care FSA elections under certain circumstances, i.e., where there is a mid-year change in dependent care providers and/or an associated change in*

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Notable Thoughts

Don't be afraid to take big steps. You can't cross a chasm in two small jumps.

David Lloyd George

provider costs so long as the dependent care provider is not a relative. The dependent care FSA election change can be adjusted higher or lower to reflect the increase or decrease in costs.

5. ***Employer Initiated Changes:*** *The new proposed regulations eliminate the previous rule that employees could only change their cafeteria plan elections if the changes in the plan's cost or coverage were initiated by third parties. Under the new proposed regulations, this requirement of third parties initiating changes is eliminated. Therefore, participants in either insured or self-funded plans can change their contribution elections if mid-year changes are made to the plan's cost or coverage under the circumstances described above.*

Final Steps – The 2001 Plan Year Is Just Around The Corner

Employers choosing to include any or all of the change events allowed under the final or new proposed regulations will need to determine when to make these changes effective with respect to their plan(s). While the employer need not adopt all or any of the status change events, some of the change events may be helpful in allowing compliance with the requirements of other federal laws, *e.g.*, FMLA and HIPAA. Employers may begin implementing the final regulations with plan years beginning on or after January 1, 2001 or sooner. There is not yet a required implementation date for the proposed regulations, but the IRS will acknowledge good faith compliance with their terms.

If the employer chooses to incorporate some or all of the change events under the final regulations (or those set forth in the proposed regulations), they must amend their plans accordingly, including modifications to the summary plan description. The employer will also need to make adjustments in its administrative policies, systems and practices currently in place to reflect the adopted changes. Third party administrators, if any, should be notified of these changes. Lastly, it is crucial that employers communicate any and all changes to their employees promptly, through standard employee communications, as well as modified SPDs or summaries of material modifications. By notifying the employees of all of their options, employees will not be able to credibly claim that they "didn't know they could make those changes," and employees become aware, as they should, of all of their options.

The first decision that the employer must make then is which, if any, of the change events it wishes to incorporate into its plan design. Once that is done, the steps mentioned above should be taken, with a focus on communication to the various parties affected by the changes. For insured benefits, this also means checking with the carriers (and for self-funded plans, checking with the stop-loss carrier, if any) to make sure that the changes desired by the employer will be accepted by the carrier(s).

The year 2001 is just around the corner. Employers must act quickly to make the appropriate changes to their plans in a timely manner. **MW**

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