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## HEALTH CARE REFORM

### CAFETERIA PLAN CHANGES

June 7, 2010

We continue our series of memos for employers on selected topics under Health Care Reform (Patient Protection and Affordable Care Act, modified by the Health Care and Education Reconciliation Act of 2010 (collectively "PPACA")) by addressing the changes applicable to cafeteria plans. To date, we have sent the following memos which may be found on our website at [www.Nyemaster.com](http://www.Nyemaster.com) by clicking on the "News" link:

- Summary of PPACA provisions
- Coverage of adult children to age 26
- Breaks for nursing mothers

This memo addresses those changes under PPACA that are applicable to cafeteria plans including:

- Restrictions on reimbursement of over-the-counter ("OTC") medicines or drugs through a health FSA
- Health FSA salary reductions limited to \$2,500 each year
- Coverage of adult children and tax exclusion for coverage and reimbursements
- Implementation of "SIMPLE" cafeteria plans

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### **What are the new restrictions imposed on reimbursements of OTC expenses through a health FSA?**

Reimbursement of OTC medicines and drugs obtained without a prescription (except insulin) is not permitted effective for taxable years beginning after December 31, 2010. It is generally agreed that “taxable year” refers to the taxable year of the employee participating in the health FSA, meaning the calendar year, which may not be the same as the plan year. Both calendar year and fiscal year plans that currently allow reimbursement for OTC expenses must be amended effective January 1, 2011 to exclude reimbursements for OTC medicines and drugs obtained without a prescription.

As we get closer to the end of the year, it will be important to keep in mind that the date the employee picks up (i.e., purchases) the OTC medication will determine whether the expense may be reimbursed. Purchases made after December 31, 2010 may not be reimbursed through a health FSA unless the employee has a prescription. This means that plans with a grace period (i.e., up to 2 ½ month extension beyond the end of the plan year to use unspent dollars in a health FSA), cannot reimburse OTC medications after December 31, 2010 unless an employee has a prescription. However, purchases made prior to January 1, 2011 may be reimbursed during the plan’s run-out period (i.e., period after the end of the plan year in which the employee has to submit claims for reimbursement) as opposed to a grace period. Although employees may consider stocking up on OTC items prior to January 1, 2011, anti-stockpiling rules only allow reimbursement of reasonable quantities of OTC medications.

### **How will the new OTC reimbursement rules affect the use of debit cards?**

Employees who routinely use debit cards to purchase OTC items will notice the impact of the new rules on debit card purchases beginning January 1, 2011. Given the additional substantiation requirement to provide a prescription for reimbursement of OTC medications, employees likely will not be able to pay for OTC expenses using their debit cards beginning January 1, 2011. Thus, it is important that employers communicate to employees during open enrollment how the changes will affect the use of debit cards.

### **What about reimbursements for OTC expenses that are not medicines or drugs?**

Under the new rules, prescriptions are required for reimbursement of OTC expenses that are considered a medicine or drug (e.g., allergy medicines, cold medicines), but OTC expenses that are not considered a medicine or drug (e.g., bandages, crutches, contact lens solution) may continue to be reimbursed after December 31, 2010 without a prescription if used for medical purposes. The definition of a prescription is unclear and whether it can be merely a doctor’s recommendation or something more.

Given the additional complexity in administering reimbursements for OTC expenses, plans may choose to limit reimbursements of OTC expenses or not reimburse OTC expenses at all. Plan

sponsors and service providers should determine how the plan will handle OTC expenses beginning January 1, 2011.

### **What action should employers take with respect to the new rules for OTC reimbursements?**

With the effective date approaching quickly, employers should take the following actions:

- 1) For plans with a grace period, employers should communicate the new rules to employees well before the end of the year so employees are aware that purchases of OTC medications without a prescription must be made prior to January 1, 2011, and not during the grace period, in order to be reimbursed.
- 2) Plan documents should be amended during 2010 to specifically exclude reimbursement of OTC medicines and drugs obtained without a prescription (and reimbursement for other OTC expenses if the plan chooses) effective January 1, 2011.
- 3) Employers sponsoring a calendar year plan should communicate the OTC changes to employees (including changes applicable to the use of debit cards) during 2010 open enrollment so employees are aware of the new rules as they make their elections for the 2011 plan year.
- 4) Employers sponsoring a fiscal year plan should communicate the OTC changes to employees (including the changes applicable to the use of debit cards) prior to the beginning of the 2010 fiscal year or as soon as possible if the 2010 fiscal year has already begun. Once a plan year has begun, it does not appear that election changes will be permitted other than during open enrollment.

### **When and how will the \$2,500 limit on salary reductions apply to health FSAs?**

The \$2,500 limit on salary reductions for health FSAs is also based on the individual's taxable year (calendar year) beginning January 1, 2013 and will be indexed for inflation. Plan documents (including SPDs and other employee communications) should be amended effective January 1, 2013 to limit salary reductions under the health FSA to \$2,500 as adjusted for cost of living increases.

Unlike the dependent care statutory limit, the \$2,500 health FSA limit applies on a per participant basis so that each spouse may make a separate \$2,500 salary reduction to a health FSA (assuming both spouses are independently eligible for their respective employer's health FSA). In addition, employer contributions to a health FSA, often called "flex credits" or "flex dollars," are not included in the \$2,500 limit if they are not subject to cash out by participants.

**How should the \$2,500 limit on health FSA salary reductions be implemented for a fiscal year plan?**

In the absence of regulatory guidance prior to January 1, 2013, it is generally recommended that a fiscal year plan be amended effective with the plan year beginning in 2012 to apply the \$2,500 limit so the limit will not be exceeded for the calendar year beginning January 1, 2013.

**How does the age 26 health coverage mandate and tax exclusion relating to adult children apply to cafeteria plans?**

First, with respect to coverage that is mandated for adult children under age 26, the mandate applies to group health plans that are not “excepted benefits” under HIPAA. Thus, the mandate requiring coverage of adult children under age 26 clearly applies to most underlying group health plans (except stand alone dental and visions plans) for which employees pay premiums pre-tax through a cafeteria plan.

Although the mandate only requires coverage of adult children until they turn 26, the tax exclusion applies until the end of the year in which the child turns 26. Thus, employees may pay for health coverage pre-tax through the cafeteria plan through December 31 of the year in which the child turns 26. If the health plan terminates coverage upon the child’s 26<sup>th</sup> birthday and the employee elects COBRA coverage for the child, COBRA premiums may also be paid pre-tax by the employee through December 31 of the year in which the child turns 26.

**Can employees receive tax-free reimbursements through a health FSA for a child under age 26?**

Yes. IRS notice 2010-38 confirms that the tax exclusion applies to reimbursements through a health FSA for an employee’s child through the end of the taxable year in which the child turns age 26.

Although most health FSAs are excepted benefits under HIPAA (unless the employer contributes at least \$500 that may be used toward an employee’s health FSA account) and, therefore, may not be subject to the mandate requiring coverage of children under age 26, we believe employees will want to take advantage of the tax exclusion for reimbursement of a child’s medical expenses not covered by the employer’s group health plan. In addition, employers and third party administrators may find it administratively easier to allow pre-tax reimbursements through a health FSA for an employee’s child through the end of the year in which the child turns 26.

**What action should employers take regarding the tax exclusion for adult children?**

Since the tax exclusion is effective now, employees may pay health insurance premiums pre-tax through the cafeteria plan and receive reimbursements through the health FSA for a child under age 26 immediately. However, depending on current language used in the cafeteria plan

document, the plan should be reviewed by legal counsel to determine whether an amendment is required to permit pre-tax salary reductions for an employee's child under the new rules. The IRS has stated that adding coverage for children up to age 26 in a cafeteria plan's health FSA will qualify as a "change in status", permitting election changes mid-year consistent with adding coverage for an adult child.

### **What is a "SIMPLE" cafeteria plan and who may sponsor these new plans?**

Effective January 1, 2011, small employers may adopt new "SIMPLE" cafeteria plans. A SIMPLE cafeteria plan provides a safe harbor from nondiscrimination testing requirements that apply to cafeteria plans and certain component plans (e.g., group term life, health FSAs and DCAPs). In the past, these nondiscrimination tests may have deterred some small employers from sponsoring cafeteria plans or prevented highly compensated or key employees of smaller employers from full participation. However, a SIMPLE cafeteria plan requires employer contributions and is subject to eligibility and participation requirements.

An employer is a small employer for purposes of sponsoring a SIMPLE cafeteria plan if it has an average of 100 or fewer employees during either of the preceding two years. If the employer was not in existence during the prior year, the determination is made based on the average number of employees that are reasonably expected to be employed on business days during the current year. Once established, an employer's SIMPLE cafeteria plan may remain in place until the employer exceeds an average of 200 or more employees during a preceding year.

### **What are the contribution, eligibility and participation requirements for SIMPLE cafeteria plans?**

The disadvantage of a SIMPLE cafeteria plan is that employer contributions are required. The required employer contribution is similar to retirement plan contributions in that the employer has a choice between offering 1) a non-elective contribution for all "qualified employees" regardless of whether they make salary reduction contributions to the plan, or 2) a matching contribution that would only apply to "qualified employees" who make salary reductions to the plan. The non-elective contribution must be a uniform percentage of at least 2% of the employee's compensation for the plan year. If the employer chooses to make a matching contribution, the contribution must be twice the employee's salary reduction contribution up to 6% of compensation. Employer contributions must be available to pay for the cost of any qualified benefit under the plan, meaning that employers cannot require employees to use the employer contribution toward just one benefit (e.g., health insurance premiums).

Eligibility and participation requirements also apply to SIMPLE plans. All employees with at least 1,000 hours of service during the preceding plan year (except employees under age 21 or with less than one year of service), must be eligible to participate. Certain collective bargaining employees and nonresident aliens may be excluded. Employees who are eligible to participate must be able to elect any benefit available under the plan.

**What should employers consider before implementing a SIMPLE cafeteria plan?**

Employers who have difficulty passing nondiscrimination tests may wish to consider implementing a SIMPLE cafeteria plan, but should also weigh the costs associated with making contributions to the plan. Employers should also consider potential pitfalls of making employer contributions to the plan such as the possibility of a health FSA no longer being an excepted benefit under HIPAA and therefore being subject to full COBRA and portability rules and any state law restrictions on employer contributions to a group health plan.

**What action should an employer take with respect to the new rules that apply to cafeteria plans?**

Given the changes imposed on cafeteria plan by PPACA and other proposed regulatory changes that have occurred over the last few years, cafeteria plans and other employee communications (e.g., SPDs and open enrollment materials) should be reviewed and updated this year. Employers who currently sponsor a cafeteria plan and are a client of Nyemaster Goode will be receiving a letter requesting permission for us to review and update their plan documents.

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