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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8878]

RIN 1545-AU61

Tax Treatment of Cafeteria Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to section 125 cafeteria plans. The final regulations clarify the circumstances under which a section 125 cafeteria plan election may be changed. The final regulations permit an employer to allow a section 125 cafeteria plan participant to revoke an existing election and make a new election during a period of coverage for accident or health coverage or group-term life insurance coverage.

DATES: Effective Date: These regulations are effective March 23, 2000.

Applicability Date: These regulations are applicable for cafeteria plan years beginning on or after January 1, 2001. See the Scope of Regulations and Effective Date portion of this preamble.

FOR FURTHER INFORMATION CONTACT: Janet A. Laufer or Christine L. Keller at (202) 622-6080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 125. Section 125 generally provides that an employee in a cafeteria plan will not have an amount included in gross income solely because the employee may choose among two or more benefits consisting of cash and "qualified benefits." A qualified benefit generally is any benefit that is excludable from gross income under an express provision of the Internal Revenue Code, including coverage under an employer-provided accident or health plan under sections 105 and 106, group-term life insurance under section 79, elective contributions under a qualified cash or deferred arrangement within the meaning of section 401(k), dependent care assistance under section 129, and adoption assistance under section 137.¹ Qualified benefits can be provided under a cafeteria plan either through insured arrangements or arrangements that are not insured.

¹ The following are not qualified benefits: products advertised, marketed, or offered as long-term care insurance; medical savings accounts under section 106(b); qualified scholarships under section 117; educational assistance programs under section 127; and fringe benefits under section 132.

In 1984 and 1989, proposed regulations were published relating to the administration of cafeteria plans.² In general, the 1984 and 1989 proposed regulations require that for benefits to be provided on a pre-tax basis under section 125, an employee may make changes during a plan year only in certain circumstances.³ Specifically, Q&A-8 of §1.125-1 and Q&A-6(b), (c), and (d) of §1.125-2 permit participants to make benefit election changes during a plan year pursuant to changes in cost or coverage, changes in family status, and separation from service.

In 1997, temporary and proposed regulations were issued addressing the standards under which a cafeteria plan may permit a participant to change his or her group health coverage election during a period of coverage to conform with the special enrollment rights under section 9801(f) (added to the Internal Revenue Code by the Health Insurance Portability and Accountability Act of 1996 (HIPAA)) and to change his or her group health or group-term life insurance coverage in a variety of change in status situations.⁴

² 49 FR 19321 (May 7, 1984) and 54 FR 9460 (March 7, 1989), respectively.

³ Those proposed regulations contain special rules with respect to flexible spending arrangements. A flexible spending arrangement (FSA) is defined in section 106(c)(2). Under section 106(c)(2), an FSA is generally a benefit program under which the maximum reimbursement reasonably available for coverage is less than 500% of the value of the coverage.

⁴ 62 FR 60196 (November 7, 1997) and 62 FR 60165 (November 7, 1997), respectively. IRS Announcement 98-105 (1998-49 I.R.B. 21 (November 23, 1998)) states that the Service will amend the effective date of those proposed and temporary regulations so that they will not be effective before plan years beginning at least 120 days after further guidance is issued.

These final regulations, which replace the 1997 temporary regulations, clarify the circumstances under which a cafeteria plan may permit an employee to revoke an existing election with respect to accident or health coverage, or group-term life insurance coverage, and make a new election during a period of coverage.

Explanation of Provisions

A. Summary.

These regulations clarify the circumstances under which a cafeteria plan may permit an employee to change his or her cafeteria plan election with respect to accident or health coverage or group-term life insurance coverage during the plan year. The regulations generally follow the existing temporary regulations, and include a variety of examples illustrating how the rules apply in specific situations.

The final regulations include two principal changes that have been made in response to public comments. First, the regulations differ from the 1997 regulations with respect to change in status events resulting from a change in employment. Commentators requested a loosening of the rules regarding when a cafeteria plan election can be changed. In response, the final rules incorporate a more flexible rule under which any change in the employment status of the employee (or a spouse or dependent of the employee) that affects that individual's eligibility under a cafeteria plan or qualified benefits plan constitutes a change in status for purposes of permitting a mid-year election change. Second, in the event of a change in an employee's marital

status or the employment status of the employee's spouse or dependent, the final regulations permit the employee to elect either to increase group-term life insurance coverage or to decrease group-term life insurance coverage. A similar rule applies with respect to disability income plans.

These final regulations were developed as part of an integrated package with proposed regulations that are being published elsewhere in this issue of the **Federal Register**. Those proposed regulations provide guidance on election changes on account of changes in status with respect to dependent care assistance and adoption assistance and provide guidance on election changes on account of changes in cost or coverage with respect to dependent care assistance, adoption assistance, accident or health coverage, and group-term life insurance coverage. The integrated package of final and proposed regulations is intended to provide clear standards for plan administration and for administration of the tax law. The standards are designed to accommodate the most common types of events of independent significance that do not occur on a regular, periodic basis and that are likely to affect an employee's decisions with respect to qualified benefits coverage.

B. Changes in Status.

Commentators on the 1997 temporary and proposed regulations requested that the description of changes in status be expanded to include work-related changes of an employee, the employee's spouse, or the employee's dependent in addition to

termination or commencement of employment or change in worksite. In response to these comments, the description of changes in status has been broadened to include a strike or lockout, and a commencement of or return from an unpaid leave of absence. In addition, the final rules incorporate a more flexible rule for other change in employment status events. Specifically, if there is a change in the employment status of the employee (or a spouse or dependent of the employee) that affects that individual's eligibility under a cafeteria plan or qualified benefits plan, then that change constitutes a change in status. For example, if an employee switches from salaried to hourly-paid status, resulting in the employee ceasing to be eligible for coverage under the plan, then that change constitutes a change in status.

Some commentators expressed concern that the 1997 temporary and proposed regulations did not permit an employee to make an election change to cover additional individuals under an accident or health plan when an employer changed its policy (e.g., to permit coverage for a parent or for a domestic partner pursuant to local law requirements). Under the 1997 temporary and proposed regulations, a change in status includes an event that causes an employee's dependent to satisfy or cease to satisfy the eligibility requirements for coverage under a plan. Thus, if an individual who is a dependent of an employee becomes eligible for coverage under the employer's health plan as a result of an amendment made to the plan during the year, that is a change in status event and, accordingly, the cafeteria plan may permit an election

change by the employee to cover the individual. These final regulations retain the rule from the 1997 temporary and proposed regulations.

These final regulations do not address when a bona fide termination of employment occurs. However, these regulations retain the example (Example 8 under paragraph (c)(4) of these final regulations) from the 1997 temporary and proposed regulations addressing the situation in which an employee terminates and resumes employment within 30 days. The effect of this example is to provide a practical safe harbor that generally may be applied by cafeteria plans without regard to other facts and circumstances. Under this example, if an employee terminates and resumes employment within 30 days and the cafeteria plan provides that the employee's election is automatically reinstated, the employer is not required to determine whether a bona fide change in status has occurred with respect to termination of employment. Conversely, the cafeteria plan may permit an employee who resumes employment more than 30 days following termination to be automatically reinstated to the prior election or to make a new election.⁵

C. Consistency Rule.

As under the 1997 temporary and proposed regulations, the final regulations require that an election change as a result of a change in status also satisfy a consistency requirement. In response to comments, the final regulations expand and

⁵ Alternatively, the cafeteria plan may prohibit an employee from participating in the cafeteria plan for that plan year upon reemployment.

clarify the consistency requirement with respect to change in status events for group-term life insurance. Under the 1997 regulations, in the case of a commencement of employment, marriage, birth, adoption, or placement for adoption, an employee could elect to increase (but not decrease) group-term life insurance coverage. The 1997 regulations also permitted an employee to elect to decrease (but not to increase) group-term life insurance coverage in the case of divorce, legal separation, annulment, or death of a spouse or dependent. Commentators suggested that these rules were too restrictive. For example, in the case of divorce, an employee may reasonably seek to increase coverage because the employee may become the sole wage-earner for the family unit as a result of the divorce. Accordingly, the final regulations provide flexibility by stating that, in the event of a change in an employee's marital status or the employment status of the employee's spouse or dependent, an employee may elect either to increase group-term life insurance coverage or to decrease group-term life insurance coverage. Also, in response to comments, a similar rule has been added that applies to election changes made with respect to disability income coverage (i.e., accident or health coverage that is neither for medical care as defined under section 213(d) nor for payments described in section 105(c)).

D. Other Changes.

Some commentators requested that the regulations prescribe a period of time by which election changes, as a result of a change in status, should be made. Consistent

with the approach taken in the 1997 regulations and in the interest of providing employers and plan administrators flexibility, the final regulations do not prescribe such a period. However, nothing in the final regulations would prevent a cafeteria plan by its terms from requiring that any election change (other than those made in connection with rights for which there are specific minimum election periods, such as under section 9801 (as added by HIPAA) and section 4980B (relating to COBRA coverage)), must be made within a specified period after a change in status event. The consistency rule in the final regulations does require that an election change made pursuant to a change in status be "on account of" a gain or loss of eligibility for coverage. This requirement follows the "on account of" language contained in the 1989 proposed regulations under §1.125-2, Q&A-6(c), and is intended to add a general condition that the election change not be made so long after the event permitting the election change that the election is not on account of the event.

In accordance with comments, examples in the regulations clarify that if, in accordance with special enrollment rights provided by HIPAA , an employee, spouse, or new dependent is entitled to enroll in a group health plan, a cafeteria plan may permit the employee to elect to enroll pre-existing dependents in the underlying group health plan.⁶ Likewise, the examples clarify that if, in accordance with the change in

⁶ No inference is intended from these or any other examples in the final regulations concerning the interpretation of special enrollment rights under section 9801(f).

status rules relating to a new spouse or dependent, an employee is entitled to elect family coverage under a group health plan, then other family members are permitted to become covered under the family coverage as a result of the election change.⁷

In response to comments, the final regulations also clarify that, in the event of a loss of Medicare or Medicaid entitlement by an employee or by the employee's spouse or dependent, a cafeteria plan may permit the employee to add health coverage under the employer's accident or health plan (and may permit cancellation or reduction in coverage if an employee, spouse, or dependent who is enrolled in an accident or health plan becomes entitled to Medicare or Medicaid).

Scope of Regulations and Effective Date

These final regulations address all of the changes in status for which a cafeteria plan may permit election changes with respect to an accident or health plan or group-term life insurance plan. However, future guidance under the cost or coverage change provision (reserved at paragraph (f) of these final regulations and included in paragraph (f) of the proposed regulations being published elsewhere in this issue of the **Federal Register**), rather than the change in status rules, would determine whether a cafeteria plan may permit affected employees to elect a new HMO option that is made

⁷ Provisions in paragraph (b) of the final regulation allowing election changes in connection with special enrollment under section 9801(f) may overlap the provisions in paragraphs (c) through (e) of the final regulations permitting election changes in other circumstances. Thus, no inference is intended that an election change permitted under paragraphs (c) through (e) is not also permitted under paragraph (b).

available during a period of coverage. Similarly, election changes may be made under the special rules relating to changes in elections by employees taking leave under the Family and Medical Leave Act of 1993 (Public Law 103-3)⁸ (as referenced at paragraph (g) of these final regulations).

Finally, these regulations do not override other cafeteria plan requirements. For example, although an employee's termination of employment is a change in status, some election changes made with respect to coverage under a health FSA on account of the termination of employment would fail to be consistent with the requirement that the operation of such arrangements exhibit the risk-shifting and risk-distribution characteristics of insurance under §1.125-1, Q&A-17 and §1.125-2, Q&A-7 of the proposed regulations. Thus, a cafeteria plan could not permit individuals terminating employment to change their health FSA elections to match the amount of premiums paid prior to termination (i.e., stop paying premiums), and continue to receive health FSA reimbursements with respect to the remainder of the period of coverage.

These regulations are applicable for cafeteria plan years beginning on or after January 1, 2001. Until the beginning of the first plan year beginning on or after January 1, 2001, taxpayers may rely on these regulations. In addition, until the beginning of the first plan year beginning on or after January 1, 2001, taxpayers may

⁸ See §1.125-3, published as a proposed rule at 60 FR 66229 (December 21, 1995).

continue to rely on the change in status rules in the 1997 regulations, as well as the change in family status rules in the pre-1997 proposed regulations.

Pursuant to section 7805(e), the 1997 temporary regulations §1.125-4T will expire within three years of the date of issuance (November 7, 2000). This Treasury decision amends the 1997 temporary regulations to add this expiration in the text of the regulations (§1.125-4T(l)).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Janet A. Laufer and Christine L. Keller, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. §1.125-4 is added to read as follows:

§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 E during the plan year. E's employer, N, offers health coverage to N's employees, and, prior to the marriage, E 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 E 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 E 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 E 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.

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 I provides group-term life insurance coverage as described under section 79. Under I's plan, an employee may elect life insurance coverage in an amount up to \$50,000. I 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, I'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 E 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, E elects no health coverage and employee-only vision coverage under V's plan. During the year, E 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) E'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 E) 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 (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):

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

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

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

a prospective election change to cancel or reduce coverage of that employee, spouse, or dependent under the accident or health plan. In addition, if an employee, spouse, or dependent who has been entitled to such coverage under Medicare or Medicaid loses eligibility for such coverage, the cafeteria plan may permit the employee to make a prospective election to commence or increase coverage of that employee, spouse, or dependent under the accident or health plan.

(f) Significant cost or coverage changes. [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.

Par. 3. §1.125-4T is amended by revising paragraph (l) to read as follows:

§1.125-4T Permitted election changes (temporary).

* * * * *

(l) Effective date. This section is applicable for plan years beginning after December 31, 1998, and on or before November 6, 2000.

Robert E. Wenzel

Deputy Commissioner of Internal Revenue

Approved: 2/23/00

Jonathan Talisman

Acting Assistant Secretary of the Treasury (Tax Policy)