

# ASPPA *asap*

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## HEART Act of 2008: Assistance for Military Personnel and Compliance Concerns for Plan Administrators - Part 2: Cafeteria Plan Issues

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In previous ASPPA *asap* 08-17, we analyzed part of the Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008, which Congress passed in May, and the President signed into law on June 17, 2008. The HEART Act amends the Internal Revenue Code and the Social Security Act to provide certain tax benefits and incentives to military personnel. Some of these amendments provide for elective or mandatory changes to employee benefit plans. The previous *asap* dealt with retirement plan issues; this *asap* will deal with the HEART Act's effect on cafeteria plan issues.

▲ **Cafeteria Plans: Qualified Reservist Distributions**  
Qualified Reservist Distributions. The HEART Act amends Code §125 to allow distributions of unused amounts in health flexible spending arrangements ("health FSAs") to reservists called to active duty. This will allow a reservist who is called to active duty and not able to fully use amounts credited in his or her health FSA to cash out the unused benefits and not forfeit them under the "use it or lose it" rule that applies to health FSAs. Specifically, the HEART Act allows (but does not require) penalty-free "qualified reservist distributions" from a health FSA without subjecting other amounts in the cafeteria plan or health FSA to immediate taxation. A qualified reservist distribution is a distribution of all or a portion of unused amounts in a health FSA belonging to a reservist ordered or called to active duty, provided (a) the order or call to active duty is for a period of over 179 days or for an indefinite period and (b) the distribution is made between the date of the order or call and the last date that reimbursements from the health FSA could otherwise be made for the plan year that includes the date of the order or call to active duty. Although not directly addressed in either the HEART Act or the Joint Committee on Taxation's (JCT's) explanation, we assume that these distributions will be taxable to the individual, whereas distributions from a health

FSA to pay for qualified medical expenses are excluded from income. This provision will apply to distributions made after the date of the HEART Act's enactment.

Action Items for Plan Sponsors and Administrators. Because this provision is not mandatory, a plan sponsor will have to determine whether it wants to make qualified reservist distributions available. If so, the plan sponsor will need to amend the plan documents accordingly. The sponsor will also need to issue summaries of material modification (SMMs) describing these distributions to all cafeteria plan participants and the next summary plan description (SPD) issued will have to reflect the availability of this new option. Those plan administrators that provide plan documents as part of services they provide to employers will also need to update their documentation to reflect this new provision.

Open Issues. This new Code provision raises a number of compliance issues, which are summarized below. Unfortunately, the JCT's explanation of this provision is only two sentences long. Thus, guidance from the Internal Revenue Service and the Treasury Department will be needed to clear up any ambiguities. This new guidance may be included in the final cafeteria plan regulations, which are currently in proposed form.

- **Tax treatment of qualified reservist distribution.** Neither the bill nor the JCT explanation state whether the distribution is taxable to the recipient. Unfortunately, the revenue table prepared by the JCT states that this provision has a negligible revenue impact, so the revenue table does not help in determining whether the distribution is taxable. However, because the bill does not provide a specific exclusion from income for a qualified reservist distribution, it is likely that this distribution will be taxable if received by an individual.

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- **Tax treatment of the cafeteria plan.** Generally, if a cafeteria plan or health FSA makes payments for amounts that are not qualified medical expenses, the entire amount available under the plan will be taxable because the plan will not be considered a cafeteria plan or health FSA. This should not be the case if a plan offers qualified reservist distributions because the bill states that providing a qualified reservist distribution does not mean that the arrangement will lose its status as a cafeteria plan or health FSA. However, it does mean that the plan sponsor or administrator must make sure that such a distribution meets the requirements for a qualified reservist distribution enumerated in the bill. This responsibility of the plan sponsor raises additional compliance questions. For example, what will be the standard for determining whether the individual meets the requirements for a qualified reservist distribution? Will the plan sponsor's cafeteria plan or health FSA be fully taxable if the plan sponsor does not check to make sure that the requirements were met?

- **Time period for making the distribution.** The distribution must be made during the period between the date that the individual is called to active duty and the last day that reimbursements could otherwise be made under the plan for the plan year that includes the day the individual is called to active duty. An interpretation of this provision that would fully effectuate the intent of the provision would be that the time period for the distribution ends on the last day that medical expenses can be reimbursed by the health FSA. That would mean that if a plan provides for a 2 ½ month "grace period" after the end of the year during which qualified medical expenses can be incurred and allows reimbursement for claims incurred during that grace period, qualified reservist distributions can be made as late as the last day that claims incurred during the grace period can be reimbursed.

- **Amount of the distribution.** The statutory text states that the amount of the distribution is "all or a portion of the balance in the employee's account," which may cause confusion, as cafeteria plans generally do not maintain actual "accounts." However, the JCT explanation only refers "the individual's FSA balance," which more accurately reflects the structure of cafeteria plans. By relying on the JCT explanation's reference to the FSA balance, the amount that can be distributed will most likely be the amount credited toward participant's health FSA as of the time of the distribution, minus the health FSA benefits already paid. Existing health FSA rules require that the maximum health FSA reimbursement amount elected by an individual for a plan year be available throughout the plan year

(minus any amounts reimbursed) regardless of the amount contributed by the individual to the health FSA. Therefore, it is possible that during a plan year, an individual can be reimbursed an amount from his or her health FSA that is greater than what he or she has contributed. The fact that a participant may be reimbursed from a health FSA an amount larger than the balance of contributions raises the question of how this requirement applies in the case of qualified reservist distributions. The IRS may address this issue in future regulatory guidance.

- **Application of nondiscrimination rules.** Because cafeteria plans and health FSAs are not required to permit qualified reservist distributions, if distributions are permitted, the nondiscrimination rules must apply. It would be helpful if the IRS made it clear that qualified reservist distributions need only be offered in a nondiscriminatory manner rather than made in a nondiscriminatory manner.