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GUIDE FOR PERMITTING MID-YEAR ELECTION CHANGES UNDER CAFETERIA PLANS

The Internal Revenue Service (“IRS”) recently provided additional guidance on when and under what conditions a cafeteria plan may permit participants to make changes to their benefit elections under a section 125 plan, otherwise known as a cafeteria plan, during a coverage period. On January 10, 2001, the IRS issued revised final and proposed regulations (the “2001 regulations”) which expand and clarify final and proposed regulations previously issued in March of last year (the “2000 regulations”). The 2001 regulations are generally effective for plan years beginning on or after January 1, 2001 but, with respect to certain changes, there is a delayed effective date of January 1, 2002. Until then, however, employers can rely on either proposed regulations issued in 1989, the 2000 regulations or the 2001 regulations.

The following provides a general summary of the circumstances under which a cafeteria plan may permit participants to change their elections with respect to accident or health coverage, group-term life insurance, health flexible spending accounts, dependent care assistance and adoption assistance during a coverage period and the changes that are permitted to be made in light of the 2001 regulations. In order for a cafeteria plan to permit changes to be made on account of the following circumstances, the terms of the cafeteria plan must specifically allow those changes.

- ◆ **HIPAA events.** A cafeteria plan may permit election changes during a coverage period that correspond to the special enrollment rights for health plans provided by the Health Insurance Portability and Accountability Act of 1996 (“HIPAA”). Generally, the events that trigger the special enrollment rights for health plans under HIPAA include:
 - An employee’s addition of a dependent through marriage, birth, adoption or placement for adoption (this also constitutes a “change of status” discussed below). HIPAA requires that a timely election to add a dependent in the case of birth, adoption or placement for adoption be retroactive to the date of birth, adoption or placement for adoption, and the 2001 regulations allow a cafeteria plan to permit an increase in an employee’s salary reduction to pay for the retroactive coverage.
 - An employee’s or dependent’s loss of coverage under another health plan resulting from (i) expiration of COBRA continuation coverage, (ii) the employee or dependent losing eligibility on account of certain events or (iii) termination of employer contributions toward coverage.
- ◆ **“Changes in Status.”** A cafeteria plan may permit election changes during a coverage period upon the occurrence of an event that constitutes a “change in status” if the change is on account of and corresponds to the event.
 - A change in status includes the following events:
 - ✓ *Changes in an employee’s legal marital status*, including marriage, death of a spouse, divorce, legal separation and annulment.
 - ✓ *Changes in the number of an employee’s dependents*, including birth, death, adoption and placement for adoption and for purposes of adoption assistance, the commencement or termination of an adoption proceeding.

- ✓ *Changes in the employment status of the employee, spouse or dependent*, including termination or commencement of employment, strike or lockout, commencement of or return from an unpaid leave of absence, change in worksite, or any other changes in employment status which affect a person's eligibility for benefits.
- ✓ *Changes in a dependent's satisfying or ceasing to satisfy eligibility requirements*, including attainment of a certain age, student status or any similar circumstance.
- ✓ *Changes in the place of residence of the employee, spouse or dependent*.
- An election change must be on account of and correspond to the change in status. For group-term life insurance and disability coverage, an election that either increases or decreases coverage in response to a change in status is deemed to correspond to a change in status.
- To ensure that an election change corresponds to a change in status event, an employer can rely on an employee's certification, provided the employer has no reason to believe the certification is incorrect.
- ◆ **Judgment, Decrees or Orders.** A cafeteria plan may permit an election change during a coverage period (i) to provide coverage for a dependent child or foster child to comply with a judgment, decree or order requiring such coverage or (ii) to cancel such coverage if an order requires another person to provide such coverage as long as that coverage is in fact provided by the other person.
- ◆ **Entitlement to Medicare or Medicaid.** A cafeteria plan may permit a prospective election change during a coverage period to correspond to an employee, spouse or dependent becoming entitled to, or losing eligibility for, Medicare or Medicaid.
- ◆ **Significant Cost or Coverage Changes.** Except with respect to health flexible spending accounts, a cafeteria plan may permit certain election changes during a coverage period on account of changes in cost or coverage, despite whether the change in cost or coverage is due to an action taken by the employee (switching from full-time to part-time status) or the employer (reducing the amount of employer contributions).
 - *Significant Increased Costs.* If the cost of a plan or benefit option significantly increases, a cafeteria plan may automatically increase affected employees' contributions. In addition, the cafeteria plan may permit an employee who had been participating in such plan or benefit option to prospectively elect another similar benefit package option or, only if no other similar benefit package option is available, to drop coverage.
 - *Significant Decreased Costs.* If the cost of a plan or benefit option significantly decreases, a cafeteria plan may automatically decrease affected employees' contributions. In addition, the cafeteria plan may permit all eligible employees, including those that were not previously participating in the plan or benefit option, to commence participation in the plan or to elect that option.
 - *Significant Curtailment Without Loss of Coverage.* If there is an overall reduction in coverage provided under a plan or benefit option that is not a loss of coverage, such as a significant increase in the deductible, the copay or out-of-pocket limits, a cafeteria plan may permit an employee who had been participating in such plan or benefit option to prospectively elect another similar benefit package option. An employee cannot, however, completely drop coverage if there is no loss of coverage.
 - *Significant Curtailment With Loss of Coverage.* If there is a loss of coverage, such as the elimination of a plan or benefit option, an HMO ceasing to be available in the area where an individual lives or the individual losing all coverage under a plan or benefit option by reason of an overall lifetime or annual limitation, a cafeteria plan may permit that employee to prospectively elect another similar benefit package option or, only if no other similar benefit package option is available, to drop coverage. A cafeteria plan may also, in its discretion, treat as a loss of coverage:

- ✓ A substantial decrease in the medical care providers available under a plan or benefit option, such as a major medical hospital ceasing to be a member of a preferred provider network or a substantial decrease in the physicians participating in a preferred provider network or an HMO;
- ✓ A reduction in the benefits for a specific type of medical condition or treatment with respect to which an employee, spouse or dependent is currently in a course of treatment; or
- ✓ Any other similar fundamental loss of coverage.
- *Addition or Improvement of a Benefit Package Option.* If a plan adds a new benefit option or if coverage under an existing benefit option is significantly improved during a period of coverage, a cafeteria plan may permit eligible employees (whether or not they have previously participated in the plan or elected the benefit option) to prospectively elect coverage under the new or improved benefit option.
- *Change in Coverage Under Another Employer Plan.* A cafeteria plan may permit a prospective election change that is on account of and corresponds to a change made under another employer plan (including a plan of the same employer, another employer or a plan of a spouse's or dependent's employer) if:
 - ✓ The other plan permits participants to make an election change in accordance with the 2001 regulations (disregarding this change in coverage under another employer plan); or
 - ✓ The period of coverage under the plan is different from the period of coverage under the other plan and the election change under the plan is made during an open enrollment period of the other plan.
- *Loss of Coverage Under Other Group Health Coverage.* A cafeteria plan may permit a prospective election change to add coverage for an employee, spouse or dependent if the employee, spouse or dependent loses coverage under any group health coverage sponsored by a governmental or educational institution, including a state children's health insurance program, a medical care program of an Indian Tribal government, a state health benefits risk pool or a foreign government group health plan.
- ◆ **Family and Medical Leave Act.** An employee taking a leave under the Family and Medical Leave Act (FMLA) may make a prospective election change for the remainder of the coverage period as provided for under the FMLA.

For further information regarding the new proposed and final cafeteria plan regulations, please call Eileen M. Liu at (312) 853-7434 or e-mail eliu@sidley.com, or any other member of the Employee Benefits Group.