

Food for Thought on Cafeteria Plans and COBRA

By Rich Glass, JD

When you think of qualified beneficiaries paying COBRA premiums, it is usually on an after-tax basis. And yet, there are several circumstances in which cafeteria plans can make the COBRA menu, transforming payments from post-tax to pre-tax.

Of course, as a preliminary matter, we all know that health flexible spending accounts (FSAs), offered through a pre-tax Section 125 cafeteria plan, are subject to COBRA on a limited basis when they are HIPAA-excepted (see ¶1216 of the *Guide*). In addition, the paths of COBRA and cafeteria plans intersect in three major ways: (1) premium reimbursement accounts; (2) severance arrangements; and (3) health savings accounts.

Premium Reimbursement Accounts

One of the oldest pieces of employer benefits guidance from the IRS is Revenue Ruling 61-146, issued in 1961. This ruling allowed employers to reimburse employees for health insurance premiums in any of three ways: upon proof of premium payment by the employee, by direct check to the insurer or by direct check payable to the insurer and the employee. This type of arrangement came to be known as a premium reimbursement account (PRA), and was recognized again in Information Letter 2006-0042.

A quarter century later, the proposed cafeteria plan regulations expanded upon the revenue ruling. These regulations clarified that an employee's COBRA premiums may be paid via the cafeteria plan even if those premiums are for coverage through another employer. This can arise in several situations, including:

- An employee loses group health coverage as a result of a reduction of hours, changing from full-time to part-time status. As long as the employee continues to receive a paycheck, the COBRA premiums can be paid on a pre-tax basis.

- A new hire comes to work for an employer, whose group health plan has a waiting period. In the interim, the employee continues COBRA coverage through the prior employer, paying the premiums on a pre-tax basis via salary reductions through the new employer's cafeteria plan.

It is unclear whether the employee could pay for spouse/dependent-only COBRA coverage through the cafeteria plan. A literal reading of regulations reveals that it must be for the employee's coverage.

In addition, an employee's premiums for individual policies can be run through a PRA. Thus, a new hire facing a waiting period could purchase a fixed-term individual policy that is effective only for the length of the waiting period, paying for those premiums on a pre-tax basis through the cafeteria plan.

Employers should take caution before adopting this type of approach. First, the premium reimbursement option must be a listed benefit in the cafeteria plan document. If it isn't listed, the document must be amended before the benefit is offered.

Second, cafeteria plans are subject to rules limiting the times in which participants may change their elections. Generally, a change in status is required to change an election mid-year. Thus, once you make an election, you are stuck with it, even if the underlying COBRA or individual coverage terminates.

Third, all premium reimbursements require written substantiation.

Fourth, while there is not clear guidance, the argument exists that the PRA constitutes a group health plan itself, thus making the underlying individual coverage subject to ERISA, COBRA and HIPAA portability



Rich Glass is chief compliance officer for Infnisource, Inc. He is a licensed attorney and brings more than 18 years of legal expertise, specializing in benefits, human resources and related regulatory compliance. He has testified before the IRS and has provided comments on regulations issued by several governmental authorities. He is a member of the Health Plan Advisory Panel at Thompson Publishing Group and Contributing Editor of Thompson's Flex Plan Handbook. He is a frequent speaker and author on various benefits, employment law and compliance issues.

See *Cafeteria Plans*, p. 10

Learn wellness strategies that improve your bottom line. Go to www.thompson.com/welln

laws. That was the unsuccessful argument made by a new hire in the 2005 case, *Cox v. Transit Group Transportation*. When the new employer fired the employee and stopped paying the COBRA premiums of his prior employer, he argued that an ERISA plan had been established. The court disagreed because the key factor was that the employee was paying the premiums and getting reimbursed. However, it should be noted that a 1998 case, *Burrill v. LECO Corp.*, had a different result, finding that an employee with a 90-day individual policy did indeed have COBRA rights under the employer's group health plan.

The qualifying events of divorce and cessation of dependent status should not be run through a cafeteria plan because the former spouse is now an ex-spouse and the former dependents are no longer dependents.

A fifth danger exists, as illustrated in the 2006 case, *Lloyd v. Harrington Benefit Services*. In that case, the new employer promised to pay the new hire's COBRA premiums but failed to send in the election form or make any payments. The new hire was without recourse because he was ultimately responsible for electing and paying for COBRA.

A sixth and final precaution is to remember that cafeteria plan benefits may only be used to pay for coverage of an employee, an employee's spouse and an employee's dependents. Therefore, the COBRA qualifying events of divorce and cessation of dependent status should not be run through a cafeteria plan because the former spouse is now an ex-spouse and the former dependents are no longer dependents.

Severance Arrangements

The rationale behind severance pay is to maintain the former employee's status quo for pay and benefits for a specific period to cushion the blow of unemployment. A cafeteria plan can help in this regard. Employers may design their plans to allow qualified beneficiaries to opt to pay for coverage with pre-tax dollars. This can be done if the severance payment is a lump sum paycheck (deducting multiple months of COBRA premiums) or in the form of salary continuation.

As with PRAs, a certain amount of caution is in order. Cafeteria plans may not defer compensation, so a lump

sum check could only cover COBRA premium payments through the end of the current plan year. Keep in mind also that cafeteria plans are subject to nondiscrimination testing, so severance arrangements can cause problems if they favor highly compensated employees or have too high a benefit concentration for key employees. Finally, the ability to use severance pay for COBRA premiums needs to be addressed in the plan document.

The proposed cafeteria plan regulations include an example of how severance arrangements work to pay COBRA premiums, concluding that “[t]hese provisions in the cafeteria plan are consistent with the requirements in section 125.”

Health Savings Accounts

A cafeteria plan is a great method for contributing to a health savings account (HSA) because employee contributions can be made on a pre-tax basis, and employer contributions can be made on a non-taxable basis. Also, the proposed cafeteria plan regulations make it clear that, unlike with other qualified benefits, HSA elections can be changed at least once per month.

The advantage of an HSA is that it is usually considered to be an individual account.

The Internal Revenue Code specifically states in Section 106 that the COBRA provisions in the code do not apply to HSAs.

However, ERISA has no such language. The U.S. Department of Labor has published two Field Assistance Bulletins (FABs) on this subject: FAB 2004-1 and FAB 2006-2. (On the other hand, high-deductible health plans (HDHPs) are typically subject to ERISA and COBRA.)

FAB 2004-1 exempts HSAs from ERISA (and consequently, COBRA and HIPAA) if participation is voluntary and the employer does not do any of the following:

- Limit the transfer of funds from one HSA to another.
- Control how HSA funds may be used (recall that they may be used to purchase non-medical care items).
- Influence the investment choices available for HSAs.
- Represent that the HSA is an ERISA plan.

See *Cafeteria Plans*, p. 11

New! *Questions Answered on Health Care Reform*. Go to ahcmedia.com/healthreform

Timing of Plan Premium Payment Does Not Negate That COBRA Notice Obligation Fulfilled

As long as a plan administrator can document that proper COBRA notice procedures were followed in response to a qualifying event, a court will have no trouble finding that the plan administrator is not liable for COBRA notice violations.

The fact that a group health plan temporarily canceled coverage before a qualifying event due to premium nonpayment did not cause an employer to be liable for alleged COBRA violations where the employer properly fulfilled its COBRA notice obligation, the federal district court in Puerto Rico ruled. The case is *Ríos v. Alternate Concepts, Inc.*, 2010 WL 5095804 (D. Puerto Rico, Nov. 3, 2010).

Facts of the Case

Alternate Concepts, Inc. had an insured group health plan. A benefits clerk was responsible for plan

Cafeteria Plans (continued from p. 10)

- Accept any form of consideration from the HSA custodian.

FAB 2006-2 expanded on the FAB 2004-1 list of don'ts with a list of dos of employer actions that will not open up the ERISA/COBRA/HIPAA can of worms:

- Unilaterally open an HSA for an employee and deposit employer funds.
- Limit how many vendors can market HSAs in the workplace.
- Choose an HSA vendor whose investment options match those offered by the employer's 401(k) plan.
- Pay HSA-related fees on behalf of employees.
- Allow contributions to be made through a cafeteria plan, reaping FICA and FUTA savings.

To date, no case has been reported where an HSA has been determined to be an ERISA plan, subject to COBRA. Practically, it is not clear how an HSA COBRA premium would be calculated. Presumably, the employer would need to continue to fund the HSA in the same manner as it would for similarly situated active employees.

Cafeteria plans and COBRA have some overlap, and it is prudent for employers to understand how this overlap can be used for the benefit of all while at the same time being cautious of the many bumps that lie along that road. 🏠

administration, which among other things, included processing the insurer's invoices for the monthly premium assessment for covered employees during the second week of the month. Alternate Concepts issued the payment to the insurer close to the end of each month.

Alternate Concepts followed the following practice when COBRA qualifying events occurred. As soon as the human resources (HR) manager or supervisor notified the benefits clerk that a qualifying event occurred, the benefits clerk accessed in her computer the COBRA notice form letter, which she personally addressed to the affected qualified beneficiaries.

The one-page letter was in Spanish and included an attachment — a COBRA pamphlet, also in Spanish, entitled "*Información Importante sobre sus Derechos a Continuación de Beneficios bajo COBRA.*" The attachment was not personalized. The clerk routinely hand delivered the COBRA letter and pamphlet to the ex-employee and gave the ex-employee an orientation regarding COBRA. When the COBRA documents were hand delivered, the benefits clerk also asked the ex-employee to countersign the first page of the document, which was the COBRA letter, as evidence of receipt. Then, the document was filed in the ex-employee's terminated file. When it was not possible to hand deliver the material, it was mailed to the former employee.

When a qualifying event occurred, the benefits clerk was also responsible for notifying the insurer in writing of that fact.

Jaime Ríos was an Alternate Concepts employee who had family coverage under the plan. Ríos' employment was terminated on Sept. 5, 2006. The company's usual COBRA procedure was followed in Ríos' case. Specifically, the benefits clerk personally addressed and signed Ríos' COBRA letter. Also, as documented in Ríos' file, the benefits clerk had an exit interview with Ríos on Sept. 7, 2006, during which Ríos signed an exit interview form and the COBRA letter as evidence of receipt. (COBRA provides that a termination or reduction in hours of employment is a qualifying event that entitles qualified beneficiaries to up to 18 months of COBRA coverage. An employer has 30 days from the qualifying event date to notify the plan administrator, who then must provide a COBRA election notice within 14 days. See ¶1122, ¶1312 and ¶1314 of the *Guide*.)

See *Premium Payment*, p. 12

Learn wellness strategies that improve your bottom line. Go to www.thompson.com/welln