

stored at -18 °C or colder within 6 hours after transfer to the final container, unless the product is to be stored as Liquid Plasma.

(b) *Fresh Frozen Plasma*. Fresh Frozen Plasma shall be prepared from blood collected by a single uninterrupted venipuncture with minimal damage to and minimal manipulation of the donor's tissue. The plasma shall be separated from the red blood cells, frozen solid within 6 hours after phlebotomy and stored at -18 °C or colder.

(c) *Liquid Plasma*. Liquid Plasma shall be separated from the red blood cells within 26 days after phlebotomy (within 40 days after phlebotomy when CPDA-1 solution is used as the anticoagulant), and shall be stored at a temperature of 1 to 6 °C within 4 hours after filling the final container.

(d) *Platelet Rich Plasma*. Platelet Rich Plasma shall be prepared from blood collected by a single uninterrupted venipuncture with minimal damage to and manipulation of the donor's tissue. The plasma shall be separated from the red blood cells by centrifugation within 4 hours after phlebotomy. The time and speed of centrifugation shall have been shown to produce a product with at least 250,000 platelets per microliter. The plasma shall be stored at a temperature between 20 to 24 °C or between 1 and 6 °C, immediately after filling the final container. A gentle and continuous agitation of the product shall be maintained throughout the storage period, if stored at a temperature of 20 to 24 °C.

(e) *Modifications of Plasma*. It is possible to separate Platelets and/or Cryoprecipitated AHF from Plasma. When these components are to be separated, the plasma shall be collected as described in § 640.32 for Plasma.

(1) Platelets shall be separated as prescribed in subpart C of part 640, prior to freezing the plasma. The remaining plasma may be labeled as Fresh Frozen Plasma, if frozen solid within 6 hours after phlebotomy.

\* \* \* \* \*

15. Section 640.54 is amended by revising paragraph (a)(2) to read as follows:

**§ 640.54 Processing.**

(a) \* \* \*

(2) The plasma shall be frozen solid within 6 hours after blood collection. A combination of dry ice and organic solvent may be used for freezing; *Provided*, That the procedure has been shown not to cause the solvent to penetrate the container or leach

plasticizer from the container into the plasma.

\* \* \* \* \*

**§ 640.56 [Amended]**

16. Section 640.56 *Quality control test for potency* is amended in the introductory text of paragraph (c) by removing "Clinical Laboratories Improvement Act of 1988" and by adding in its place "Clinical Laboratories Improvement Amendments of 1988".

17. Section 640.62 is revised to read as follows:

**§ 640.62 Medical supervision.**

A qualified licensed physician shall be on the premises when donor suitability is being determined, immunizations are being made, whole blood is being collected, and red blood cells are being returned to the donor.

18. Section 640.63 is amended by revising paragraph (c)(11) to read as follows:

**§ 640.63 Suitability of donor.**

\* \* \* \* \*

(c) \* \* \*

(11) Freedom from a history of viral hepatitis;

\* \* \* \* \*

**§ 640.71 [Amended]**

19. Section 640.71 *Manufacturing responsibility* is amended in the introductory text of paragraph (a) by removing "Clinical Laboratories Improvement Act of 1988" and by adding in its place "Clinical Laboratories Improvement Amendments of 1988".

Dated: December 29, 2000.

**Margaret M. Dotzel,**

*Associate Commissioner for Policy.*

[FR Doc. 01-533 Filed 1-9-01; 8:45 am]

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**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Part 1**

[TD 8921]

RIN 1545-AY23

**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 cafeteria plan may permit an employee to change his or her cafeteria plan election with respect to accident or health coverage, group-term life insurance coverage, dependent care assistance and adoption assistance during the plan year.

**DATES:** *Effective Date:* These regulations are effective January 10, 2001.

*Applicability Date:* See the *Scope of Regulations and Effective Date* portion of this preamble.

**FOR FURTHER INFORMATION CONTACT:** Christine L. Keller or Janet A. Laufer 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 of the Internal Revenue Code (Code). 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 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.<sup>1</sup> Qualified benefits can be provided under a cafeteria plan either through insured arrangements or arrangements that are not insured.

In 1984 and 1989, proposed regulations were published relating to cafeteria plans.<sup>2</sup> 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. 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,

<sup>1</sup> Section 125(f) provides that the following are not qualified benefits (even though they are generally excludable from gross income under an express provision of the Internal Revenue Code: 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.

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

changes in family status, and separation from service.

In 2000, final regulations<sup>3</sup> were issued permitting a participant in a cafeteria plan to change his or her accident or health coverage election during a period of coverage in specific circumstances such as where special enrollment rights arise under section 9801(f) (added to the Code by the Health Insurance Portability and Accountability Act of 1996 (HIPAA))(110 Stat. 1936), where eligibility for Medicare or Medicaid is gained or lost, or where a court issues a judgment, decree, or order requiring that an employee's child or foster child who is a dependent receive health coverage. In addition, the final regulations permit an employee to change his or her accident or health coverage election or group-term life insurance election if certain change in status rules are satisfied.

On the same day that the final regulations were issued, proposed regulations<sup>4</sup> were also issued containing change in status rules that apply to other types of qualified benefits (*i.e.*, dependent care assistance and adoption assistance) and describing the circumstances under which changes in the cost or coverage of qualified benefits provide a basis for changes in cafeteria plan elections. The IRS and Treasury received written comments on the proposed regulations and held a public hearing on August 17, 2000. Having considered the comments and the statements made at the hearing, the IRS and Treasury revise the final regulations and adopt the proposed regulations as modified by this Treasury decision. The comments and revisions are discussed below.

## Explanation of Provisions

### 1. Changes in the March 2000 Final Regulations

With respect to group-term life insurance and disability coverage, the final regulations issued earlier this year provided flexibility by stating that, in the event of a change in an employee's marital status or a change in the employment status of the employee's spouse or dependent, an employee may elect either to increase such coverage or to decrease such coverage.<sup>5</sup>

<sup>3</sup> TD 8878 at 65 FR 15548 (March 23, 2000). These final regulations were preceded by temporary regulations issued in 1997. See 62 FR 60196 (November 7, 1997) and 62 FR 60165 (November 7, 1997).

<sup>4</sup> REG-117162-99 at 65 FR 15587 (March 23, 2000).

<sup>5</sup> For example, an employee might seek to increase group-term life insurance due to a marriage (because of the need to provide income to the new spouse in the event that the chief wage-earner dies)

Commentators recommended that this rule also apply in the case of birth, adoption, placement for adoption, or death. The argument was made that in these other situations—because these types of coverage are generally designed to provide income, instead of expense reimbursements—it may be appropriate for the employee to seek to increase or decrease the coverage. In accordance with these recommendations and in the interest of simplicity, the final regulations have been modified to allow participants to increase or decrease these types of coverage for all change of status events. Further, as also suggested by commentators, the final regulations have been modified to expand the rule to apply to coverage to which section 105(c) (which is coverage for permanent loss or loss of use of a member or function of the body) applies.

Commentators requested clarification as to how the election change rules with respect to special enrollment rights under section 9801(f) (enacted under HIPAA) apply to a participant who marries if the group health plan allows the participant to change his or her health coverage election retroactively to the date of the marriage. In response to this comment, language has been added to an example in the final regulations to clarify that an election change can be funded through salary reduction under a cafeteria plan only on a prospective basis, except for the retroactive enrollment right under section 9801(f) that applies in the case of an election made within 30 days of a birth, adoption, or placement for adoption.

With respect to accident or health coverage, the consistency rule in the final regulations requires that any employee who wishes to decrease or cancel coverage because he or she becomes eligible for coverage under a spouse's or dependent's plan due to a marital or employment change in status can do so only if he or she actually obtains coverage under that other plan. Commentators requested clarification as to the type of proof an employer must receive to satisfy this rule, expressing concern that a plan could not implement a change on a timely basis because of a need to obtain proper proof of the other coverage. An example in the final regulations has been revised to make it clear that employers may generally rely on an employee's certification that the employee has or will obtain coverage under the other plan (assuming that the employer has no

or to decrease group-term life insurance due to a marriage (because the new spouse may be a wage-earner who can support the family in the event that the employee dies).

reason to believe that the employee certification is incorrect).

The final regulations allow a participant to change his or her election if a judgment, decree or order resulting from a divorce, legal separation, annulment, or change in legal custody requires that an employee's spouse, former spouse, or other individual provide accident or health coverage for the employee's child or for a foster child who is a dependent of the employee. The final regulations were modified to clarify that the participant can only change his or her election if the spouse, former spouse, or other individual actually provides accident or health coverage for the child.

### 2. Changes From the March 2000 Proposed Regulations

The final regulations being issued today are generally consistent with the proposed regulations that were issued earlier this year, but include various modifications.

#### Cost and coverage rules

The proposed regulations included rules allowing election changes in connection with a significant increase in cost or a significant curtailment in coverage, irrespective of whether the plan is insured or not insured. These cost and coverage rules (and the other rules in paragraph (f) of § 1.125-4) do not apply with respect to coverage under a health FSA.<sup>6</sup> However, all of the rules in paragraphs (a) through (e) and paragraph (g) of the final regulations under § 1.125-4 do apply with respect to coverage under a health FSA. One modification reflected in the final regulations is to clarify that the cost increase rules apply when the amount of an employee's elective contributions under section 125 increases either due to the employee contributing a larger portion of the total cost of the qualified benefits plan (which might occur, for example, if part-time employees pay a larger portion of a plan's cost and the employee switches to part-time status) or due to an increase in the total cost of the qualified benefits plan.

In response to comments, modifications were also made to allow election changes during a period of coverage when there is a significant *decrease* in the cost of a qualified benefits plan or in the cost of a benefits package option under the qualified

<sup>6</sup> 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. A health FSA is an accident or health plan that is an FSA.

benefits plan, as well as when there is a significant increase. Under the regulations as modified, if there is a significant decrease in the cost of a qualified benefits plan during the plan year, the final regulations permit a cafeteria plan to allow all employees, even those who have not previously participated in the cafeteria plan, to elect to participate in the qualified benefits plan through the cafeteria plan. Similarly, if there is a significant decrease in the cost of a benefits package option during the plan year, the final regulations permit a cafeteria plan to allow all eligible employees to elect that option (including employees who have elected another option, as well as those who have not previously participated in the cafeteria plan).

Further, in response to comments, modifications were also made to allow midyear election changes when there is a significant improvement in the coverage provided under a benefit package option, as well as when there is a new benefit package option offered under the plan.

Commentators also requested clarification as to whether a cafeteria plan could allow participants to drop coverage in response to a significant change in the cost or coverage of a qualified benefit. The final regulations clarify this issue, and provide that, if there is no other similar coverage, employees may drop coverage (including a change from family to single coverage) in response either to an increase in the cost of a qualified benefit or to a loss of coverage. The regulations also permit an employee to elect similar coverage in response to a significant curtailment in coverage. However, the regulations do not allow an employee to drop coverage altogether if there is a significant curtailment in coverage that does not constitute a loss of coverage. The regulations list the curtailments that are treated as a loss of coverage for this purpose, and include a complete loss of coverage (such as when an HMO ceases to be available in an area where an individual resides, or when an employee or a covered member of the employee's family loses all coverage under a benefit package option by reason of a lifetime or annual limitation). In addition, the final regulations allow a cafeteria plan, in its discretion,<sup>7</sup> to treat certain other events as a loss of coverage. These events include a substantial decrease in medical care providers (such as a major

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 the employee or the employee's spouse or dependent is currently in a course of treatment,<sup>8</sup> or any other similar fundamental loss of coverage.

For purposes of these rules, a significant curtailment occurs only if there is an overall reduction in coverage provided so as to constitute reduced coverage generally (*i.e.*, a reduction in the fair market value of the coverage). Therefore, in most cases, the loss of one particular physician in a network does not constitute a significant curtailment.

In response to comments, the rule under the proposed regulations that allowed an employee to change his or her election in response to a change made under a spouse's or dependent's plan has been clarified and broadened. Under the final regulations, the rule applies to coverage available from any employer plan, including any plan of the same employer and any plan of a different employer. In addition, the regulations have been modified to allow an employee to elect to participate in a cafeteria plan if the employee (or the employee's spouse or dependent) loses coverage under a group health plan sponsored by a governmental or educational institution, such as a state program under the State Children Health Insurance Program (SCHIP).<sup>9</sup> The regulations do not allow a cafeteria plan participant to cease participation in a cafeteria plan if he or she becomes eligible for SCHIP coverage during the year because of a concern that such a rule would violate a fundamental principle of Title XXI of the Social Security Act that SCHIP coverage not supplant existing public or private coverage.

#### 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, including changes with respect to accident or health coverage, group-term life insurance, dependent care assistance and adoption assistance. In addition, the regulations contain

<sup>8</sup> Any reduction in coverage that affects a specific individual must not violate the prohibition in section 9802 against discrimination on the basis of health status (and parallel HIPAA provisions in the Employee Retirement Income Security Act of 1974 and the Public Health Service Act). See §§ 54.9802-1 and 54.9802-1T(b)(2).

<sup>9</sup> Added to the Society Security Act by section 4901 of the Balanced Budget Act of 1997, Public Law 105-33 (August 5, 1997).

guidance concerning election changes that are permitted because of changes in the cost or coverage of a qualified benefit plan.

Unless specifically noted, these regulations do not override other cafeteria plan requirements such as the rules pertaining to health flexible spending arrangements, and the rules concerning the Family and Medical Leave Act (Public Law 103-3 (107 Stat. 6)).<sup>10</sup>

The changes made by these regulations with respect to the March 2000 final regulations are applicable for cafeteria plan years beginning on or after January 1, 2001, except that the clarification made in paragraph (d)(1)(ii)(B) of these regulations (relating to a spouse, former spouse, or other individual obtaining accident or health coverage for an employee's child in response to a judgment, decree, or order) is applicable for cafeteria plan years beginning on or after January 1, 2002. With respect to the change made in paragraph (d)(1)(ii)(B) of these regulations, taxpayers may, until January 1, 2002, rely on either paragraph (d)(1)(ii)(B) of these regulations or the final regulations published in March 2000 (as § 1.125-4(d)(1)(ii)).

The changes made from the March 2000 proposed regulations (including the rules relating to cost or coverage in paragraph (f) of these regulations) are applicable for cafeteria plan years beginning on or after January 1, 2002. With respect to these changes (including the rules relating to cost or coverage in paragraph (f) of these regulations), taxpayers may, until January 1, 2002, rely on either these regulations, the proposed regulations published in March 2000 (under § 1.125-4), or the cost or coverage change rules in the 1989 proposed regulations (at § 1.125-2 (Q&A-6(b))).

#### 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

<sup>10</sup> See § 1.125-3, published as a proposed rule at 60 FR 66229 (December 21, 1995).

<sup>7</sup> Such discretion may be exercised on a case by case basis, provided that the exercise of discretion satisfies section 125(c) which prohibits discrimination in favor of highly compensated participants.

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 Christine L. Keller and Janet A. Laufer, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). 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 amended by:

1. Revising paragraphs (b)(2) *Example 2*(ii).
2. Revising paragraph (c)(1) and adding paragraph (c)(2)(vi).
3. Adding a sentence to the end of paragraph (c)(3)(i).
4. Removing the last sentence in paragraph (c)(3)(iii) and adding a sentence in its place.
5. Adding paragraph (c)(4) *Example 3* (iii).
6. Revising paragraph (c)(4) *Example 4* (ii) and adding paragraph (iii).
7. Adding paragraph (c)(4) *Example 9* and (c)(4) *Example 10*.
8. Revising paragraph (d)(1)(ii).
9. Revising paragraphs (f), (g), (i)(3) and (i)(4).
10. Adding a sentence at the end of paragraph (i)(8), and adding paragraph (i)(9).
11. Revising paragraph (j).

The additions and revisions read as follows:

**§ 1.125-4 Permitted election changes.**

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

*Example 2.* \* \* \*

(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 accident or 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 accident or 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. Since no retroactive coverage is required in the event of marriage under section 9801(f), *E*'s salary reduction election may only be changed on a prospective basis. (*E*'s marriage to *F* 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) *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 (defined in paragraph (i)(8) of this section) 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—

- (i) A change in status described in paragraph (c)(2) of this section occurs; and
- (ii) The election change satisfies the consistency rule of paragraph (c)(3) of this section.

\* \* \* \* \*

(2) \* \* \*

(vi) *Adoption assistance.* For purposes of adoption assistance provided through a cafeteria plan, the commencement or termination of an adoption proceeding.

(3) *Consistency rule*—(i) *Application to accident or health coverage and group-term life insurance.* \* \* \* A change in status that affects eligibility under an employer's plan includes a change in status that results in an increase or decrease in the number of an employee's family members or dependents who may benefit from coverage under the plan.

\* \* \* \* \*

(iii) *Application of consistency rule.* \* \* \* With respect to group-term life insurance and disability coverage (as defined in paragraph (i)(4) of this section), an election under a cafeteria plan to increase coverage (or an election to decrease coverage) in response to a change in status described in paragraph (c)(2) of this section is deemed to correspond with that change in status as required by paragraph (c)(3)(i) of this section.

(4) \* \* \*

*Example 3.* \* \* \*

(iii) In addition, under paragraph (f)(4) of this section, if *F* makes an election change to cover *G* under *F*'s employer's plan, then *E* may make a corresponding change to elect employee-only coverage under *P*'s cafeteria plan.

*Example 4.* \* \* \*

(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 elect the indemnity option or HMO #2 or to cancel accident or health coverage.

(iii) The change in work location has no effect on *A*'s eligibility under *R*'s health FSA, so no change in *A*'s health FSA is authorized under this paragraph (c).

\* \* \* \* \*

*Example 9.* (i) Employee *A* has one child, *B*. Employee *A*'s employer, *X*, maintains a calendar year cafeteria plan that allows employees to elect coverage under a dependent care FSA. Prior to the beginning of the calendar year, *A* elects salary reduction contributions of \$4,000 during the year to fund coverage under the dependent care FSA for up to \$4,000 of reimbursements for the year. During the year, *B* reaches the age of 13, and *A* wants to cancel coverage under the dependent care FSA.

(ii) When *B* turns 13, *B* ceases to satisfy the definition of qualifying individual under section 21(b)(1) of the Internal Revenue Code. Accordingly, *B*'s attainment of age 13 is a change in status under paragraph (c)(2)(iv) of this section that affects *A*'s employment-related expenses as defined in section 21(b)(2). Therefore, *A* may make a corresponding change under *X*'s cafeteria plan to cancel coverage under the dependent care FSA.

*Example 10.* (i) Employer *Y* maintains a calendar year cafeteria plan under which full-time employees may elect coverage under either an indemnity option or an HMO. Employee *C* elects the employee-only indemnity option. During the year, *C* marries *D*. *D* has two children from a previous marriage, and has family group health coverage in a cafeteria plan sponsored by *D*'s employer, *Z*. *C* wishes to change from employee-only indemnity coverage to HMO coverage for the family. *D* wishes to cease coverage in *Z*'s group health plan and certifies to *Z* that *D* will have family coverage under *C*'s plan (and *Z* has no reason to believe the certification is incorrect).

(ii) The marriage is a change in status under paragraph (c)(2)(i) of this section. Under the consistency rule in paragraph (c)(3) of this section, *Y*'s cafeteria plan may permit *C* to change his or her salary reduction contributions to reflect the change from employee-only indemnity to HMO family coverage, and *Z* may permit *D* to revoke coverage under *Z*'s cafeteria plan.

(d) \* \* \* (1) \* \* \*

(ii) Permits the employee to make an election change to cancel coverage for the child if:

- (A) The order requires the spouse, former spouse, or other individual to provide coverage for the child; and
- (B) That coverage is, in fact, provided.

\* \* \* \* \*

(f) *Significant cost or coverage changes*—(1) *In general.* Paragraphs (f)(2) through (5) of this section set forth rules for election changes as a result of changes in cost or coverage. This paragraph (f) does not apply to an

election change with respect to a health FSA (or on account of a change in cost or coverage under a health FSA).

(2) *Cost changes*—(i) *Automatic changes*. If the cost of a qualified benefits plan increases (or decreases) during a period of coverage and, under the terms of the plan, employees are required to make a corresponding change in their payments, the cafeteria plan may, on a reasonable and consistent basis, automatically make a prospective increase (or decrease) in affected employees' elective contributions for the plan.

(ii) *Significant cost changes*. If the cost charged to an employee for a benefit package option (as defined in paragraph (i)(2) of this section) significantly increases or significantly decreases during a period of coverage, the cafeteria plan may permit the employee to make a corresponding change in election under the cafeteria plan. Changes that may be made include commencing participation in the cafeteria plan for the option with a decrease in cost, or, in the case of an increase in cost, revoking an election for that coverage and, in lieu thereof, either receiving on a prospective basis coverage under another benefit package option providing similar coverage or dropping coverage if no other benefit package option providing similar coverage is available. For example, if the cost of an indemnity option under an accident or health plan significantly increases during a period of coverage, employees who are covered by the indemnity option may make a corresponding prospective increase in their payments or may instead elect to revoke their election for the indemnity option and, in lieu thereof, elect coverage under another benefit package option including an HMO option (or drop coverage under the accident or health plan if no other benefit package option is offered).

(iii) *Application of cost changes*. For purposes of paragraphs (f)(2)(i) and (ii) of this section, a cost increase or decrease refers to an increase or decrease in the amount of the elective contributions under the cafeteria plan, whether that increase or decrease results from an action taken by the employee (such as switching between full-time and part-time status) or from an action taken by an employer (such as reducing the amount of employer contributions for a class of employees).

(iv) *Application to dependent care*. This paragraph (f)(2) applies in the case of a dependent care assistance plan only if the cost change is imposed by a dependent care provider who is not a relative of the employee. For this

purpose, a relative is an individual who is related as described in section 152(a)(1) through (8), incorporating the rules of section 152(b)(1) and (2).

(3) *Coverage changes*—(i) *Significant curtailment without loss of coverage*. If an employee (or an employee's spouse or dependent) has a significant curtailment of coverage under a plan during a period of coverage that is not a loss of coverage as described in paragraph (f)(3)(ii) of this section (for example, there is a significant increase in the deductible, the copay, or the out-of-pocket cost sharing limit under an accident or health plan), the cafeteria plan may permit any employee who had been participating in the plan and receiving that coverage to revoke his or her election for that coverage and, in lieu thereof, to elect to receive on a prospective basis coverage under another benefit package option providing similar coverage. Coverage under a plan is significantly curtailed only if there is an overall reduction in coverage provided under the plan so as to constitute reduced coverage generally. Thus, in most cases, the loss of one particular physician in a network does not constitute a significant curtailment.

(ii) *Significant curtailment with loss of coverage*. If an employee (or the employee's spouse or dependent) has a significant curtailment that is a loss of coverage, the plan may permit that employee to revoke his or her election under the cafeteria plan and, in lieu thereof, to elect either to receive on a prospective basis coverage under another benefit package option providing similar coverage or to drop coverage if no similar benefit package option is available. For purposes of this paragraph (f)(3)(ii), a loss of coverage means a complete loss of coverage under the benefit package option or other coverage option (including the elimination of a benefits package option, an HMO ceasing to be available in the area where the individual resides, or the individual losing all coverage under the option by reason of an overall lifetime or annual limitation). In addition, the cafeteria plan may, in its discretion, treat the following as a loss of coverage—

(A) A substantial decrease in the medical care providers available under the option (such as a major 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);

(B) A reduction in the benefits for a specific type of medical condition or treatment with respect to which the

employee or the employee's spouse or dependent is currently in a course of treatment; or

(C) Any other similar fundamental loss of coverage.

(iii) *Addition or improvement of a benefit package option*. If a plan adds a new benefit package option or other coverage option, or if coverage under an existing benefit package option or other coverage option is significantly improved during a period of coverage, the cafeteria plan may permit eligible employees (whether or not they have previously made an election under the cafeteria plan or have previously elected the benefit package option) to revoke their election under the cafeteria plan and, in lieu thereof, to make an election on a prospective basis for coverage under the new or improved benefit package option.

(4) *Change in coverage under another employer plan*. A cafeteria plan may permit an employee to make a prospective election change that is on account of and corresponds with a change made under another employer plan (including a plan of the same employer or of another employer) if—

(i) The other cafeteria plan or qualified benefits plan permits participants to make an election change that would be permitted under paragraphs (b) through (g) of this section (disregarding this paragraph (f)(4)); or

(ii) The cafeteria plan permits participants to make an election for a period of coverage that is different from the period of coverage under the other cafeteria plan or qualified benefits plan.

(5) *Loss of coverage under other group health coverage*. A cafeteria plan may permit an employee to make an election on a prospective basis to add coverage under a cafeteria plan for the 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 the following—

(i) A State's children's health insurance program (SCHIP) under Title XXI of the Social Security Act;

(ii) A medical care program of an Indian Tribal government (as defined in section 7701(a)(40)), the Indian Health Service, or a tribal organization

(iii) A State health benefits risk pool;

or

(iv) A Foreign government group health plan.

(6) *Examples*. The following examples illustrate the application of this paragraph (f):

*Example 1.* (i) A calendar year cafeteria plan is maintained pursuant to a collective

bargaining agreement for the benefit of Employer *M*'s employees. The cafeteria plan offers various benefits, including indemnity health insurance and a health FSA. As a result of mid-year negotiations, premiums for the indemnity health insurance are reduced in the middle of the year, insurance co-payments for office visits are reduced under the indemnity plan by an amount which constitutes a significant benefit improvement, and an HMO option is added.

(i) Under these facts, the reduction in health insurance premiums is a reduction in cost. Accordingly, under paragraph (f)(2)(i) of this section, the cafeteria plan may automatically decrease the amount of salary reduction contributions of affected participants by an amount that corresponds to the premium change. However, the plan may not permit employees to change their health FSA elections to reflect the mid-year change in copayments under the indemnity plan.

(ii) Also, the decrease in co-payments is a significant benefit improvement and the addition of the HMO option is an addition of a benefit package option. Accordingly, under paragraph (f)(3)(ii) of this section, the cafeteria plan may permit eligible employees to make an election change to elect the indemnity plan or the new HMO option. However, the plan may not permit employees to change their health FSA elections to reflect differences in co-payments under the HMO option.

*Example 2.* (i) Employer *N* sponsors an accident or health plan under which employees may elect either employee-only coverage or family health coverage. The 12-month period of coverage under *N*'s cafeteria plan begins January 1, 2001. *N*'s employee, *A*, is married to *B*. Employee *A* elects employee-only coverage under *N*'s plan. *B*'s employer, *O*, offers health coverage to *O*'s employees under its accident or health plan under which employees may elect either employee-only coverage or family coverage. *O*'s plan has a 12-month period of coverage beginning September 1, 2001. *B* maintains individual coverage under *O*'s plan at the time *A* elects coverage under *N*'s plan, and wants to elect no coverage for the plan year beginning on September 1, 2001, which is the next period of coverage under *O*'s accident or health plan. *A* certifies to *N* that *B* will elect no coverage under *O*'s accident or health plan for the plan year beginning on September 1, 2001 and *N* has no reason to believe that *A*'s certification is incorrect.

(ii) Under paragraph (f)(4)(ii) of this section, *N*'s cafeteria plan may permit *A* to change *A*'s election prospectively to family coverage under that plan effective September 1, 2001.

*Example 3.* (i) Employer *P* sponsors a calendar year cafeteria plan under which employees may elect either employee-only or family health coverage. Before the beginning of the year, *P*'s employee, *C*, elects family coverage under *P*'s cafeteria plan. *C* also elects coverage under the health FSA for up to \$200 of reimbursements for the year to be funded by salary reduction contributions of \$200 during the year. *C* is married to *D*, who is employed by Employer *Q*. *Q* does not maintain a cafeteria plan, but does maintain

an accident or health plan providing its employees with employee-only coverage. During the calendar year, *Q* adds family coverage as an option under its health plan. *D* elects family coverage under *Q*'s plan, and *C* wants to revoke *C*'s election for health coverage and elect no health coverage under *P*'s cafeteria plan for the remainder of the year.

(ii) *Q*'s addition of family coverage as an option under its health plan constitutes a new coverage option described in paragraph (f)(3)(ii) of this section. Accordingly, pursuant to paragraph (f)(4)(i) of this section, *P*'s cafeteria plan may permit *C* to revoke *C*'s health coverage election if *D* actually elects family health coverage under *Q*'s accident or health plan. Employer *P*'s plan may not permit *C* to change *C*'s health FSA election.

*Example 4.* (i) Employer *R* maintains a cafeteria plan under which employees may elect accident or health coverage under either an indemnity plan or an HMO. Before the beginning of the year, *R*'s employee, *E* elects coverage under the HMO at a premium cost of \$100 per month. During the year, *E* decides to switch to the indemnity plan, which charges a premium of \$140 per month.

(ii) *E*'s change from the HMO to indemnity plan is not a change in cost or coverage under this paragraph (f), and none of the other election change rules under paragraphs (b) through (e) of this section apply.

(iii) Although *R*'s health plan may permit *E* to make the change from the HMO to the indemnity plan, *R*'s cafeteria plan may not permit *E* to make an election change to reflect the increased premium. Accordingly, if *E* switches from the HMO to the indemnity plan, *E* may pay the \$40 per month additional cost on an after-tax basis.

*Example 5.* (i) Employee *A* is married to Employee *B* and they have one child, *C*. Employee *A*'s employer, *M*, maintains a calendar year cafeteria plan that allows employees to elect coverage under a dependent care FSA. Child *C* attends *X*'s on site child care center at an annual cost of \$3,000. Prior to the beginning of the year, *A* elects salary reduction contributions of \$3,000 during the year to fund coverage under the dependent care FSA for up to \$3,000 of reimbursements for the year. Employee *A* now wants to revoke *A*'s election of coverage under the dependent care FSA, because *A* has found a new child care provider.

(ii) The availability of dependent care services from the new child care provider (whether the new provider is a household employee or family member of *A* or *B* or a person who is independent of *A* and *B*) is a significant change in coverage similar to a benefit package option becoming available. Because the FSA is a dependent care FSA rather than a health FSA, the coverage rules of this section apply and *M*'s cafeteria plan may permit *A* to elect to revoke *A*'s previous election of coverage under the dependent care FSA, and make a corresponding new election to reflect the cost of the new child care provider.

*Example 6.* (i) Employee *D* is married to Employee *E* and they have one child, *F*. Employee *D*'s employer, *N*, maintains a calendar year cafeteria plan that allows

employees to elect coverage under a dependent care FSA. Child *F* is cared for by *Y*, *D*'s household employee, who provides child care services five days a week from 9 a.m. to 6 p.m. at an annual cost in excess of \$5,000. Prior to the beginning of the year, *D* elects salary reduction contributions of \$5,000 during the year to fund coverage under the dependent care FSA for up to \$5,000 of reimbursements for the year. During the year, *F* begins school and, as a result, *Y*'s regular hours of work are changed to five days a week from 3 p.m. to 6 p.m. Employee *D* now wants to revoke *D*'s election under the dependent care FSA, and make a new election under the dependent care FSA to an annual cost of \$4,000 to reflect a reduced cost of child care due to *Y*'s reduced hours.

(ii) The change in the number of hours of work performed by *Y* is a change in coverage. Thus, *N*'s cafeteria plan may permit *D* to reduce *D*'s previous election under the dependent care FSA to \$4,000.

*Example 7.* (i) Employee *G* is married to Employee *H* and they have one child, *J*. Employee *G*'s employer, *O*, maintains a calendar year cafeteria plan that allows employees to elect coverage under a dependent care FSA. Child *J* is cared for by *Z*, *G*'s household employee, who is not a relative of *G* and who provides child care services at an annual cost of \$4,000. Prior to the beginning of the year, *G* elects salary reduction contributions of \$4,000 during the year to fund coverage under the dependent care FSA for up to \$4,000 of reimbursements for the year. During the year, *G* raises *Z*'s salary. Employee *G* now wants to revoke *G*'s election under the dependent care FSA, and make a new election under the dependent care FSA to an annual amount of \$4,500 to reflect the raise.

(ii) The raise in *Z*'s salary is a significant increase in cost under paragraph (f)(2)(ii) of this section, and an increase in election to reflect the raise corresponds with that change in status. Thus, *O*'s cafeteria plan may permit *G* to elect to increase *G*'s election under the dependent care FSA.

*Example 8.* (i) Employer *P* maintains a calendar year cafeteria plan that allows employees to elect employee-only, employee plus one dependent, or family coverage under an indemnity plan. During the middle of the year, Employer *P* gives its employees the option to select employee-only or family coverage from an HMO plan. *P*'s employee, *J*, who had elected employee plus one dependent coverage under the indemnity plan, decides to switch to family coverage under the HMO plan.

(ii) Employer *P*'s midyear addition of the HMO option is an addition of a benefit package option. Under paragraph (f) of this section, Employee *J* may change his or her salary reduction contributions to reflect the change from indemnity to HMO coverage, and also to reflect the change from employee plus one dependent to family coverage (however, an election of employee-only coverage under the new option would not correspond with the addition of a new option). Employer *P* may not permit *J* to change *J*'s health FSA election.

(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 103-3 (107 Stat. 6)) may revoke an existing election of accident or 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.

\* \* \* \* \*

(i) \* \* \*

(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, and, for purposes of dependent care assistance provided through a cafeteria plan, a dependent means a qualifying individual (as defined in section 21(b)(1)) with respect to the employee.

(4) *Disability coverage.* Disability 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. For purposes of this section, disability coverage includes payments described in section 105(c).

\* \* \* \* \*

(8) *Qualified benefits plan.* \* \* \* A plan does not fail to be a qualified benefits plan merely because it includes an FSA, assuming that the FSA meets the requirements of section 125 and the regulations thereunder.

(9) *Similar coverage.* Coverage for the same category of benefits for the same individuals (e.g., family to family or single to single). For example, two plans that provide coverage for major medical are considered to be similar coverage. For purposes of this definition, a health FSA is not similar coverage with respect to an accident or health plan that is not a health FSA. A plan may treat coverage by another employer, such as a spouse's or dependent's employer, as similar coverage.

(j) *Effective date—(1) General rule.* Except as provided in paragraph (j)(2) of this section, this section is applicable for cafeteria plan years beginning on or after January 1, 2001.

(2) *Delayed effective date for certain provisions.* The following provisions are applicable for cafeteria plan years beginning on or after January 1, 2002: paragraph (c) of this section to the extent applicable to qualified benefits other than an accident or health plan or a group-term life insurance plan; paragraph (d)(1)(ii)(B) of this section

(relating to a spouse, former spouse, or other individual obtaining accident or health coverage for an employee's child in response to a judgment, decree, or order); paragraph (f) of this section (rules for election changes as a result of cost or coverage changes); and paragraph (i)(9) of this section (defining similar coverage).

#### **§ 1.125-4T [Removed]**

**Par. 3.** Section 1.125-4T is removed.

**Robert E. Wenzel,**

*Deputy Commissioner of Internal Revenue.*

Approved: December 15, 2000.

**Jonathan Talisman,**

*Acting Assistant Secretary of the Treasury (Tax Policy).*

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## **DEPARTMENT OF THE TREASURY**

### **Internal Revenue Service**

#### **26 CFR Part 54**

[TD 8928]

RIN 1545-AW94

#### **Continuation Coverage Requirements Applicable to Group Health Plans**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations that provide guidance on certain issues that arise in connection with the COBRA continuation coverage requirements applicable to group health plans. The regulations in this document supplement final COBRA regulations published on February 3, 1999, in the **Federal Register**. The regulations will generally affect sponsors and administrators of, and participants in, group health plans, and they provide plan sponsors and plan administrators with guidance necessary to comply with the law.

**DATES:** *Effective date:* These regulations are effective January 10, 2001.

*Applicability dates:* For dates of applicability, see the discussion under the heading **EFFECTIVE DATE** in this preamble.

**FOR FURTHER INFORMATION CONTACT:** Yurlinda Mathis at 202-622-6080 (not a toll-free number).

#### **SUPPLEMENTARY INFORMATION:**

##### **Background**

The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) imposes continuation coverage

requirements on group health plans in certain situations. This document contains amendments to the COBRA health care continuation coverage regulations in 26 CFR part 54. Proposed regulations interpreting COBRA were published in the **Federal Register** on June 15, 1987 (52 FR 22716). On February 3, 1999, final COBRA regulations were published in the **Federal Register** (64 FR 5160) (the 1999 final regulations), and a notice of proposed rulemaking (REG-121865-98) was published the same day (64 FR 5237) for certain issues not addressed in the final regulations (the 1999 proposed regulations). A public hearing was held on June 8, 1999. In addition, written comments responding to the notice of proposed rulemaking and to the final regulations were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

#### **Explanation and Summary of Comments**

##### *Small Employer Plan Exception*

Group health plans maintained by an employer that had fewer than 20 employees on a typical business day in the previous calendar year are not subject to COBRA. The 1999 proposed regulations relating to plans maintained by an employer with fewer than 20 employees in the previous calendar year are adopted as final regulations without change. Unlike the 1987 proposed regulations, the 1999 proposed regulations use a full-time equivalency method in counting part-time employees for purposes of determining if an employer had fewer than 20 employees. Several commenters expressed disapproval of this approach or inquired why it was being considered.

The 1987 proposed regulations contained rules about how to count part-time employees. An example can be used to illustrate how the 1987 rules were proposed to apply. In a calendar year two employers each employ 15 full-time employees and 12 part-time employees. Each part-time employee works 15 hours per week. Each employer has six typical business days each week. One employer schedules all 12 of the part-time employees to work two-and-a-half hours each typical business day per week. The other employer staggers the schedule of the part-time employees so that they each work seven-and-a-half hours on two typical business days per week, so that four part-time employees work on each typical business day. Under the 1987