MEMORANDUM

TO: Indiana Statewide CEOs

FROM: Charles W. Ritz III

DATE: December 11, 2009

RE: IS Cafeteria Plan – AFLAC style health policies

We have received inquiries this week and last regarding adding or keeping AFLAC style health insurance programs in the local distribution cooperative's adoption of the Indiana Statewide Cafeteria Plan. In particular, these are plans that offer to pay incurred charges for a condition or type of hospital care without regard to the precise amount being charged by the health care provider or paying a benefit if a particular disease or condition is diagnosed even if there is no incurred charge. The IRS adopted proposed cafeteria plan regulations in 2007 that rewrote or clarified the cafeteria plan rules. Those proposed regulations are now in effect until the final regulations are adopted.

Section 1.125-1(n) establishes the rule for accidental and health plans that may be offered through a cafeteria plan. The general rule in Section 1.125(n)(1) requires that such accident and health plans must satisfy section 105(b) and (h) of the Internal Revenue Code. In a later section of the proposed regulations, there is clarification about the Internal Revenue Code Section 105(b) requirements.

In particular, Section 1.125-6(a)(3)(ii) of the proposed cafeteria plan regulations reads in pertinent part as follows:

> "A cafeteria plan benefit through which an employee receives reimbursements of medical expenses is excludable under section 105(b) only if reimbursements from the plan are made specifically to reimburse the employee for medical expenses (as defined in section 213(d) incurred by the employee or the employee's spouse or dependents during the period of coverage. Amounts paid to an employee as reimbursement are not paid specifically to reimburse the employee for medical expenses if the plan provides that the employee is entitled, or operates in a manner that entitles the employee, to receive the amounts, in the form of cash … or irrespective of whether the employee…incurs medical expenses during the period of coverage…. A plan under which employees … will receive reimbursement for medical expenses up to a specified amount, and if they incur no medical expenses will receive cash … in lieu of the reimbursements is not a benefit qualifying for the exclusion under sections 106 and 105(b). See 1.105-2. This is the case without regard to whether

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> the benefit was purchased with contributions made at the employer's discretion, at the employee's discretion (for example by salary reduction election), or pursuant to a collective bargaining agreement."

The benefits described in the proposed regulation set out above that don't meet the exclusion under sections 106 and 105(b) appear to me to be much like some of the AFLAC policies. To allow them to be included in the participation agreement and thus in the 125 plan appears to jeopardize the plan's tax preferred status. Until this question is cleared up by additional proposed regulations or the final 125 regulations, the type of plan described should not be included as a benefit in the 125 plan or in your participation agreement.

You may offer such programs to your employees outside the cafeteria plan on a payroll deduction program but the premiums would not be paid with pre-tax income.

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