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Section 125 Cafeteria Plans:
The Top Five Issues for Employers

Audio

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Cafeteria Plans: The Big Picture

The Gateway to Pre-Tax Contributions

A Simple Concept Wrapped in a Complex Rule

- Employees generally take for granted the fact that they can contribute to health and welfare benefits on a pre-tax basis through payroll
- This is actually the product of a tangled web of cafeteria plan rules that permit employees to avoid constructive receipt—a concept most have never considered
- The election rules in Section 125 are very strict, and there is no corrections program to prevent a full loss of tax-advantaged status for failure to follow
- This makes understanding and complying with the Section 125 rules more important than most appreciate—and it puts the cafeteria plan at the forefront of many compliance issues

Top Five Section 125 Issues for Employers

1) Why Does 125 Matter: Safe harbor from doctrine of constructive receipt

2) Plan Document Requirements: Prospective written plan document required

3) Making/Changing Elections: Irrevocable elections and permitted election change events

4) Use-It-Or-Lose It: Grace period, run-out period, forfeitures, carryovers, oh my!

5) Nondiscrimination: The basics for each NDT, the weeds for 55% average benefits test

1. Why Does §125 Matter?

The Safe Harbor from Constructive Receipt

Why Does Section 125 Matter?
Safe Harbor from Constructive Receipt

Section 125 is **the exclusive means** by which an employer can offer employees an election between taxable income and nontaxable benefits on a tax-advantaged basis.

Without a Cafeteria Plan:
Constructive Receipt (Taxable)

General Rule:

- Employees must include in income any amount which they actually or constructively receive
- Means that the election between taxable income (including cash) and nontaxable benefits results in gross income to the employee—even the employees who elect benefits!

Cites:

- IRC §451; Treas. Reg. §1.451-1(a)

Cafeteria Plan:
Pre-Tax Contributions

General Rule:

- Section 125 cafeteria plans avoid constructive receipt issues
- Allows employees to make a choice between taxable cash income and nontaxable benefits
- Means employees electing to make a salary reduction election to pay for health and welfare benefits on a pre-tax basis will not receive taxable income on the taxable cash the employees could have received

Cites:

- IRC §125; Prop. Treas. Reg. §1.125-1(b)(1)

Why Does Section 125 Matter?
Safe Harbor from Constructive Receipt

Section 125 is **the exclusive means** by which an employer can offer employees an election between taxable income and nontaxable benefits on a tax-advantaged basis.

Without a Cafeteria Plan:
Constructive Receipt (Taxable)

Example:

- The ABC group health plan premium is $500/month
- The employer pays $350/month
- The employee-share of the premium is $150/month

Result:

- Employees who enroll with a salary reduction election of $150/month are still taxed on the $150 in taxable cash they could have received

Cafeteria Plan:
Pre-Tax Contributions

Example:

- Same example, but with Section 125 cafeteria plan in place

Result:

- Employees who enroll with a salary reduction election of $150/month contribute on a pre-tax basis
- No constructive receipt of the $150 available as taxable cash
- Employer and employee avoid FICA taxes (6.2% Social Security, 1.45% Medicare) on the contributions, too!

Why Does Section 125 Matter?
Qualified Benefits

Section 125 may permit employees to choose between taxable cash and "qualified benefits" through a cafeteria plan. Only qualified benefits can be part of a cafeteria plan.

Qualified Benefits:
Employee Pre-Tax Contributions

- Group Health Plan (Medical, Dental, Vision)
- Health FSA, Dependent Care FSA
- HSA
- Group Term Life ($50k coverage cap)
- AD&D
- Hospital Indemnity/Cancer Insurance
- Disability (generally contributions or benefits are taxable)
- 401(k) Plan (cashable flex credits, uncommon)
- Adoption Assistance (no FICA exemption, uncommon)
- PTO Buying/Selling (uncommon)

Non-Qualified Benefits:
Not Part of Cafeteria Plan

- Commuter Transit/Vanpool/Parking (§132 provides for employee pre-tax contributions)
- HRA (no employee contributions permitted)
- Tuition Assistance (employer tax-free reimbursement permitted under §127 or §132)
- 403(b) Plan (different from 401(k)!)
- Long-Term Care Insurance
- Individual Medical Policies (prohibited by ACA, proposed regulations would permit in 2020 if purchased off Exchange)

2. Plan Document
Timing & Content Rules

Cafeteria Plan Document: Prospective Adoption/Amendment

Retroactive Adoption Prohibited

- The Section 125 cafeteria plan needs to be signed (adopted) on or before the first day of the plan year that it will be effective
- If an employer implements a cafeteria plan with an effective date prior to the date the document is signed (i.e., with a retroactive effective date) the IRS could find that the document is not a valid cafeteria plan
- That would result in all employee health and welfare premium and FSA pre-tax elections becoming taxable to the employees
  - *American Family Mutual Insurance Co. v. United States*, 815 F. Supp. 1206, 1214 (W.D. Wis. 1992)
    - Employees participated in health FSA before cafeteria plan was adopted
    - Court found contributions must be included in employees' taxable income
    - Employer's tax liability from the error was $433,000
  - *Wollenburg v. United States*, 75 F. Supp. 2d 1032, 1036 (D. Neb. 1999)
    - Court relied on *American Family* to assess taxes on health FSA contributions made prior to plan being adopted in December of plan's calendar plan year (similar result)

Prospective Amendment or Restatement Adoption

- Any subsequent amendment to or restatement of the plan document must be prospective
  - Section 125 cafeteria plan amendment or restatement cannot have retroactive effect
  - Employer must sign the amendment or restatement on or before the date for which it is to be effective
- Retroactive effective dates do not receive Section 125 safe harbor from constructive receipt
  - This could result in the employee H&W premium and FSA pre-tax elections becoming taxable

Cafeteria Plan Document: Required Content

Written Plan Requirements

Prop. Treas. Reg. §1.125-1(c)(1)

- The Section 125 regulations provide that the written plan document must include:
  - A specific description of each of the benefits available through the plan, including the periods during which the benefits are provided (the periods of coverage)
  - The plan's rules governing participation, and specifically requiring that all participants in the plan be employees
  - The procedures governing employees' elections under the plan, including the period when elections may be made, the periods with respect to which elections are effective, and providing that elections are irrevocable (outside of the permitted election change events)
  - The manner in which employer contributions may be made under the plan (employee salary reduction election, employer nonelective contributions, flex credits, etc.)
  - The maximum amount of elective contributions (i.e., salary reduction) available to any employee through the plan (e.g., $2,700 health FSA, $5,000 dependent care FSA)
  - The plan year of the cafeteria plan
  - The special rules that apply to FSAs (e.g., use-it-or-lose-it rule, uniform coverage for health FSA)
  - A description of the plan's grace period or carryover period (if offered)
  - If the plan offers PTO buying/selling (uncommon), special ordering rules that apply

3. Making/Changing Elections
The Irrevocability Rule

Making/Changing Elections: General Rule

Section 125 Irrevocable Election Requirement

- The general rule under Section 125 for ongoing employees is that all elections (including an election not to participate) must be:
  1) ***Made prior to the start of the plan year; and***
  2) ***Irrevocable for the duration of the plan year unless the employee experiences a permitted election change event.***

Potential Consequences of Failure to Follow these Rules

- If an employer's cafeteria plan were to permit employees to make any mid-year (i.e., after the start of the plan year) election changes without experiencing a permitted election change event (or without making the election change within the plan's timing window, which is generally 30 days):
  - The plan would violate the irrevocable election rules described above
  - The Section 125 rules provide that the IRS could cause the entire cafeteria plan to lose its tax-advantaged status if discovered on audit
  - This would result in all elections becoming taxable for all employees

No Correction Program

- There is no formal IRS correction program for employers under Section 125!
  - The tax qualification rules for qualified retirement plans, which include correction procedures through the Employee Plans Compliance Resolution System (EPCRS), do not apply to cafeteria plans
  - Upon audit, IRS has discretion to impose full loss of tax-advantaged status in any non-compliance scenario—no matter how seemingly minor or commonplace

Making/Changing Elections: General Rule

Prop. Treas. Reg. §1.125-1(c)(7):

(7) Operational failure.

(i) In general. If the cafeteria plan fails to operate according to its written plan or otherwise fails to operate in compliance with section 125 and the regulations, the plan is not a cafeteria plan and employees' elections between taxable and nontaxable benefits result in gross income to the employees.

(ii) Failure to operate according to written cafeteria plan or section 125. Examples of failures resulting in section 125 not applying to a plan include the following—

(A) Paying or reimbursing expenses for qualified benefits incurred before the later of the adoption date or effective date of the cafeteria plan, before the beginning of a period of coverage or before the later of the date of adoption or effective date of a plan amendment adding a new benefit;

(B) Offering benefits other than permitted taxable benefits and qualified benefits;

(C) Operating to defer compensation (except as permitted in paragraph (o) of this section);

(D) Failing to comply with the uniform coverage rule in paragraph (d) in §1.125-5;

(E) Failing to comply with the use-or-lose rule in paragraph (c) in §1.125-5;

(F) Allowing employees to revoke elections or make new elections, except as provided in §1.125-4 and paragraph (a) in §1.125-2;

(G) Failing to comply with the substantiation requirements of § 1.125-6;

(H) Paying or reimbursing expenses in an FSA other than expenses expressly permitted in paragraph (h) in §1.125-5;

(I) Allocating experience gains other than as expressly permitted in paragraph (o) in §1.125-5;

(J) Failing to comply with the grace period rules in paragraph (e) of this section; or

(K) Failing to comply with the qualified HSA distribution rules in paragraph (n) in §1.125-5.

Making/Changing Elections: General Rule

Prop. Treas. Reg. §1.125-2(a):

(a) Rules relating to making and revoking elections.

(1) Elections in general. A plan is not a cafeteria plan unless the plan provides in writing that employees are permitted to make elections among the permitted taxable benefits and qualified benefits offered through the plan for the plan year (and grace period, if applicable). All elections must be irrevocable by the date described in paragraph (a)(2) of this section except as provided in paragraph (a)(4) of this section. An election is not irrevocable if, after the earlier of the dates specified in paragraph (a)(2) of this section, employees have the right to revoke their elections of qualified benefits and instead receive the taxable benefits for such period, without regard to whether the employees actually revoke their elections.

(2) Timing of elections. In order for employees to exclude qualified benefits from employees' gross income, benefit elections in a cafeteria plan must be made before the earlier of—

(i) The date when taxable benefits are currently available; or

(ii) The first day of the plan year (or other coverage period).

(3) Benefit currently available to an employee-in general. Cash or another taxable benefit is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable benefit at the employee's discretion. However, cash or another taxable benefit is not currently available to an employee if there is a significant limitation or restriction on the employee's right to receive the benefit currently. Similarly, a benefit is not currently available as of a date if the employee may under no circumstances receive the benefit before a particular time in the future. The determination of whether a benefit is currently available to an employee does not depend on whether it has been constructively received by the employee for purposes of section 451.

(4) Exceptions to rule on making and revoking elections. If a cafeteria plan incorporates the change in status rules in §1.125-4, to the extent provided in those rules, an employee who experiences a change in status (as defined in §1.125-4) is permitted to revoke an existing election and to make a new election with respect to the remaining portion of the period of coverage, but only with respect to cash or other taxable benefits that are not yet currently available. See paragraph (c)(1) of this section for a special rule for changing elections prospectively for HSA contributions and paragraph (r)(4) in §1.125-1 for section 401(k) elections. Also, only an employee of the employer sponsoring a cafeteria plan is allowed to make, revoke or change elections in the employer's cafeteria plan. The employee's spouse, dependent or any other individual other than the employee may not make, revoke or change elections under the plan.

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Making/Changing Elections: Open Enrollment

No Mandatory Open Enrollment Timeframe

- The Section 125 rules do not specify any period during which an employer is required to offer its open enrollment for the next plan year (nor does ERISA or any other applicable law)
- The only requirement under Section 125 is that the election be made prior to the start of the plan year (any other election change would be mid-year and require one of the listed events)

What About Post-Open Enrollment Election Change Requests?

- The OE period is established for the employer's convenience and administrative reasons
- There is no legal issue with allowing employees to make elections all the way up to the last second before the start of the new plan year
- Employers may therefore permit exceptions to allow election changes after OE ends (but *before the plan year begins*) as long as they are comfortable with the precedent established
- Employers often want to permit employees to change elections after the employer's OE closes because of the employee's changed decision or alleged mistake
- This creates an ERISA plan precedent requiring the employer to provide the same opportunity to other employees in a similar situation who request a post-OE but pre-plan year election change
  - The main reason for employers structuring OE as a set period to end in advance of the plan year is for administrative purposes
  - If employees were able to make election changes all the way up to the last day of the current plan year (12/31 for a calendar plan year) it would be very difficult to implement their elections prior to the next period of coverage (plan year)

Making/Changing Elections: Open Enrollment

Open Enrollment Best Practice Approaches

- Employers have two best practice options for handling post-OE election change requests:

1) Enforce the end of the OE as a hard deadline after which no employees may change their elections; **OR**
2) Permit post-OE election changes with a hard outer limit prior to the start of the plan year after which the employer will not accept any other post-OE election changes—regardless of the circumstances.
   - Example: Hard outer limit of two weeks in advance of the plan year (12/15 for a calendar plan year)
   - This ensures that the precedent established is managed in a manner that permits all elections for the new plan year (1/1 for a calendar plan year) to be timely implemented

What Happens When the Plan Year Starts?

- Generally there is no ability to change an employee's election because the election is irrevocable under Section 125 as of the start of the plan year
- Even if an employer were to assume the risk under Section 125, it would still have insurance carrier (or stop-loss provider) limitations and an ERISA plan precedent to address
- In some rare circumstances, the IRS informal "doctrine of mistake" may apply to permit a late election change after the plan year has started
  - This requires "clear and convincing evidence" of a mistaken election, which is a very high bar to clear
  - Later slides address mid-year exceptions and the doctrine of mistake in much more detail

Making/Changing Elections: New Hires

General Rule: Prospective Election

- The general rule under Section 125 for mid-year election changes, including for new hires, is that any election change must be prospective in effect
- This means that the employee's pre-tax contribution cannot relate to coverage in effect prior to the date of the election

Special New Hire Rule: Retroactive Elections 30 Days from Date of Hire

- The Section 125 rules provide that an election may be retroactive to the date of hire as long as it is made within 30 days of the date of hire
  - ***Example:*** *New employee hired March 21 to ABC employer with DOH eligibility for coverage*
  - ***Result:*** *If employee makes election by April 20, the employee can pay for the coverage pre-tax through the cafeteria plan retroactive to March 21 (DOH)*

Plans That Don't Offer DOH Eligibility with 30-Day Election Window

- There is no option for new hires to pay for the period of coverage prior to the date of the election (e.g., 60-day election window, eligibility is first of the month, 30 days, etc. after hire)
- Options for employers in these situations:
  - The employer would have to pay the full cost of the retroactive period (i.e., waive the employee-share of the premium for the period prior to the date of the election);
  - The employer would require the employee pay for the retroactive coverage period on an after-tax basis (i.e., the employee pays outside of the cafeteria plan for the period prior to the election); **OR**
  - Coverage would be effective no sooner than the date the employee elects to enroll (i.e., no retroactive coverage prior to the date of the election)

Making/Changing Elections:
Mid-Year Election Changes

Permitted Election Change Event Required

- The general rule under Section 125 for ongoing employees is that all elections (including an election not to participate) must be:
  - *1) Made prior to the start of the plan year; and*
  - *2) Irrevocable for the duration of the plan year* ***unless the employee experiences a permitted election change event.***
- Employers do not have to include all permitted election change events in the cafeteria plan, but generally all do (subject to any limitations imposed by the insurance carrier)
- Most cafeteria plans provide that employees have 30 days to make an election change from the date of the permitted election change event

Change in Status Events

- This is the broadest section of permitted election change events in the Section 125 regulations that come up the most often
- Generally requires that the election change be on account of and correspond with the event
  - Commonly referred to as the “consistency rule”

Other Permitted Election Change Events

- HIPAA special enrollment events, cost changes, plan changes, ACA exchange events, COBRA qualifying events, QMCSO/NMSN, Medicare/CHIP events, FMLA events
  - There are a lot of potential permitted election change events out there, many with special rules!

Making/Changing Elections:
Mid-Year Election Changes

ABD Section 125 Cafeteria Plan Permitted Election Change Event Chart

- Click ***here*** for a summary overview of the permitted election change events!

2019 Section 125 Cafeteria Plan: Permitted Election Change Event Chart

Section 125 Cafeteria Plan Rules for Administering Mid-Year Employee Election Change Requests

According to IRS guidelines (Treas. Reg. §1.125-4), participants can change their employee benefits elections under a Cafeteria Plan either (1) during an open enrollment period; or (2) mid-year pursuant to a permitted election change event.

The purpose of this chart is to identify examples of employee, spouse, or dependent life events that may create a permitted election change event. This chart does not address plan changes (e.g., change in plan design, change in plan costs) that may also create a permitted election change event. Furthermore, this chart assumes that the organization's Section 125 Cafeteria Plan Document is drafted to allow all of the available permitted election change events recognized by the IRS. **You must make your election change request within 30 days of the event. The plan cannot accept any election change once the 30-day window has closed.**

Consistency Rule:

For certain life events referred to as a "change in status," the election change generally must be consistent with the event. This means that the election change must be on account of and correspond with the event. The six categories of change in status events subject to this consistency rule are:

- Change in employee's legal marital status
- Change in number of dependents
- Change in employment status
- Dependent satisfies (or ceases to satisfy) dependent eligibility requirements
- Change in residence
- Commencement or termination of adoption proceedings

Status Event	Medical	Dental	Vision	Flexible Spending Accounts
Marriage **Note:** Plans that cover domestic partners should generally follow the same guidelines. However, unless the domestic partner is a tax dependent, these Section 125 Cafeteria Plan rules technically do not apply because the employee pays for domestic partner coverage on an after-tax basis. See page 9 for additional provisions addressing termination of coverage for a non-tax dependent domestic partner.	***You may:*** • Enroll yourself, your new spouse and any eligible dependent children. • Add your new spouse and any eligible dependent children to your plan. • Cancel your coverage if you enroll in your new spouse's group plan. Coverage/Cancellation is generally effective as of the first of the month following your election change request. **HIPAA Special Enrollment Event: Permits you to change benefit plan options.**	***You may:*** • Enroll yourself, your new spouse and any eligible dependent children. • Add your new spouse and any eligible dependent children to your plan. • Cancel your coverage if you enroll in your new spouse's group plan. Coverage/Cancellation is generally effective as of the first of the month following your election change request.	***You may:*** • Enroll yourself, your new spouse and any eligible dependent children. • Add your new spouse and any eligible dependent children to your plan. • Cancel your coverage if you enroll in your new spouse's group plan. Coverage/Cancellation is generally effective as of the first of the month following your election change request.	***You may:*** **Health Care FSA** • Enroll/Increase your contributions for the remainder of the plan year. • Revoke/decrease your if you or your dependent(s) enroll in the new spouse's health plan. **Dependent Care FSA** • Enroll if you gain an eligible dependent, and your spouse is employed/ disabled/ FT student. • Increase/decrease your contributions for the remainder of the plan year, if expenses increase/decrease as result of marriage. • Stop participating if spouse is not employed/ disabled/ FT student. Coverage/Cancellation is generally effective as of the first of the month following your election change request.

Making/Changing Elections:
HIPAA Special Enrollment Events

Which Events Qualify?

- The following events qualify as HIPAA special enrollment events:
  - Loss of eligibility for other group health coverage or individual insurance coverage
  - Loss of Medicaid/CHIP eligibility or becoming eligible for a state premium assistance subsidy under Medicaid/CHIP
  - Acquisition of a new spouse or dependent by marriage, birth, adoption, or placement for adoption
- The plan must permit employees to make medical election changes as required by HIPAA

Right to Change Medical Plan Options

- Upon experiencing a HIPAA special enrollment event, the plan is required to allow the employee to select any medical benefit package under the plan
  - For example, move from Kaiser to UHC, Cigna to Kaiser, HMO Low to PPO High, etc.

General 30-Day Election Period

- Employees must have a period of at least 30 days from the date of the event to change their election pursuant to a HIPAA special enrollment event
  - Longer periods would need to be approved by the insurance carrier or stop-loss provider

Medicaid/CHIP: Special 60-Day Election Period

- When employees lose Medicaid/CHIP eligibility, or where they gain eligibility for a state premium assistance subsidy under Medicaid/CHIP, they must have at least 60 days from the date of the event to change their election
  - This is a good ERISA trivial pursuit question

Making/Changing Elections:
HIPAA Special Enrollment Events

Effective Date: Generally First of the Month Following Election

- The general rule is that an election to enroll in coverage pursuant to a HIPAA special enrollment event must be effective no later than the first of the month following the date of the election change request
  - ***Example 1:*** *Jack marries Jill on April 19, and he submits the election change request to enroll Jill on April 22. Jill's coverage should be effective no later than May 1.*
  - ***Example 2:*** *Jack marries Jill on April 19, but does not submit the election change request to enroll Jill until May 14. Jill's coverage should be effective no later than June 1.*

Birth/Adoption: Coverage Retroactive to the Date of the Event

- Where an employee has a new child through birth, adoption, or placement for adoption, coverage for the new child must be effective as of the date of the event
  - In other words, coverage is effective the date of the birth, adoption, or placement for adoption
  - ***Example:*** *Jack's spouse Jill gives birth to a child on July 19. Jack submits the election change to enroll the child on August 14. The child's coverage must be effective as of July 19 (the date of birth)*

Existing Dependents: No Special Enrollment Rights

- Upon birth, the rules limit the special enrollment rights to the employee, the spouse, and any newly acquired dependents (i.e., the newborn child)
- Any other dependents (e.g., siblings of the newborn child) are not entitled to special enrollment rights upon the employee's acquisition of the new dependent through birth
  - The exclusion of existing dependents from special enrollment rights prevents the employee from having the right to add an existing child to the plan upon the birth of the new child

Making/Changing Elections: Substantiation of Events

Generally No Requirement for Employee to Provide Documentation

- The Section 125 rules do not require any specific substantiation procedures for an employer to confirm that an employee has experienced a permitted election change event
  - Almost always fine for the employer to rely solely on the employee's certification that the event has occurred—without any form of documentation beyond the certification to support the event

Exception: Employer Suspects Fraud

- The only time the Section 125 rules specifically require supporting documents (beyond the employee's certification) to substantiate the event is where the employer has reason to believe that the employee's certification is fraudulent or otherwise incorrect
  - In those circumstances, the employer must request documentation to substantiate the event before implementing the requested election change

Best Practice: Be Consistent and Keep Records

- Regardless of which approach the employer takes, it should:
  a) Apply the approach consistently (i.e., require supporting documents or not consistently)
  b) Keep a record of the employee's certification of the event (e.g., the ben admin system's record of the employee verification of the event) for all election changes

Relevant Cite

- 66 Fed. Reg. 1837, 1838 (Jan. 10, 2001)
  - https://www.federalregister.gov/documents/2001/01/10/01-258/tax-treatment-of-cafeteria-plans
  - *"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 reason to believe that the employee certification is incorrect)."*

Making/Changing Elections: Mid-Year Exceptions (Not Recommended)

Employees Often Ask for Exceptions to Enroll Mid-Year

- Three main reasons why we recommend not permitting employees to enroll themselves or a dependent mid-year without experiencing a permitted election change event (or after the plan's 30-day window to make the election change):
  - **Section 125 Cafeteria Plan Rules**
  - **Insurance Carrier Policy Limitations**
  - **ERISA Plan Precedent**

Reason #1: Section 125 Cafeteria Plan Rules

- Failure to adhere to the permitted election change event rules set forth in Treas. Reg. §1.125-4 can cause the entire cafeteria plan to lose its tax-advantaged status
  - This would result in all elections becoming taxable to all employees
  - Could permit employee to pay after-tax outside the cafeteria plan, but still issues #2 and #3 below

Reason #2: Insurance Carrier Policy Limitations

- Insurance carriers (and stop-loss providers) generally will pay claims only for employees and dependents who are eligible and properly enrolled
  - Carriers generally will permit employees to enroll only at OE, upon new hire/newly eligible status, and within 30 days of experiencing a permitted election change event
  - If a carrier discovers that an employee was allowed to enroll in any other situation, the carrier would be within its right to deny paying all claims for that employee/dependent
  - That would make the employer responsible for self-funding all claims (worst-case scenario!)
  - Crucial that carrier agree to any exception for mid-year enrollment if employer makes exception

Making/Changing Elections: Mid-Year Exceptions (Not Recommended)

Employees Often Ask for Exceptions to Enroll Mid-Year

- Three main reasons why we recommend not permitting employees to enroll themselves or a dependent mid-year without experiencing a permitted election change event (or after the plan's 30-day window to make the election change):
  - **Section 125 Cafeteria Plan Rules**
  - **Insurance Carrier Policy Limitations**
  - **ERISA Plan Precedent**

Reason #3: ERISA Plan Precedent

- ERISA requires that employers administer the plan in accordance with the terms of the written plan document
  - Plan document will not permit employees to make election changes unless they experience a permitted election change event and make the election within the required timeframe (30 days)
  - If the employer makes an exception, the employer has interpreted the plan's terms to permit the exception, and this interpretation must be applied consistently for all similarly situated employees
- This means that exceptions create an ERISA plan precedent requiring the plan to permit election changes for all employees in similar circumstances
  - An employee denied ability to change election in similar circumstances would have a potential claim for ERISA breach of fiduciary duty or claim for benefits

Summary

- For these three reasons, we recommend not making mid-year enrollment exceptions
  - Employers making exceptions anyway should carefully consider all three issues first!

Making/Changing Elections:
Doctrine of Mistake (Rare)

IRS has provided informal guidance that an employee's election can be undone if there is "clear and convincing evidence" that a mistake has been made. This is a *very high standard*! Facts and circumstances must be completely persuasive to qualify—which rarely occurs. The strong presumption is always the employee has just changed his mind.

Example #1:
Dependent Care FSA
No Qualifying Dependents

Employee must have no dependents who can benefit from the FSA to be "clear and convincing"

- Employee has no children, all of employee's children are age 13 or older with no disabilities, or the employee does not have a disabled spouse or dependent whose expenses would be eligible
- Mistake as to the benefit's scope or tax treatment does not qualify
- Corrected by refunding employee's contributions as taxable income subject to withholding and payroll taxes

Example #2:
Ben Admin System Causes Incorrect Health Plan Election

Employee attempted to complete election process, but the ben admin system failed to properly finalize

- Should be some forensic analysis of the enrollment system available to confirm that the employee actually partially completed the election process
- Ideally would show elections that employee provisionally made
- This would be a strong argument for clear and convincing evidence of a mistaken election (i.e., mistake failure to elect)
- Carrier (or stop-loss) must still approve!

Making/Changing Elections:
Doctrine of Mistake (Rare)

IRS has provided informal guidance that an employee's election can be undone if there is "clear and convincing evidence" that a mistake has been made. This is a *very high standard*! Facts and circumstances must be completely persuasive to qualify—which rarely occurs. The strong presumption is always the employee has just changed his mind.

Suggested Approach:
Clear Documentation

If the employer undoes the election based on the doctrine of mistake, the employer should:

- Clearly document the reason for undoing the election (i.e., the facts supporting clear and convincing evidence of the mistake);
- Require the employee to sign off on these facts; **and**
- Be clear in any communication that it is only very rare circumstances like these that an employer could change or revoke an existing election without experiencing a permitted election change event

Sample Language:
Employee Attestation

I understand the general rule under Section 125 is that all cafeteria plan elections (including an election not to participate by failure to elect) must be:

- *Made prior to the start of the plan year; and*
- *Irrevocable for the plan year unless the employee experiences a permitted election change event set forth in Treas. Reg. §1.125-4.*

The circumstances in this situation constitute a rare exception under the IRS "doctrine of mistake" approach because there is clear and convincing evidence of a mistaken election.

4. Use-It-Or-Lose-It
The Basic Rule for FSAs

Use-It-Or-Lose-It:
General Rule for FSAs

Section 125 Use-It-Or-Lose-It-Rule

- Health FSA and Dependent Care FSA are components of the Section 125 cafeteria plan
- A fundamental limitation is that FSA elections are subject to the use-it-or-lose-it rule
- Means that after the end of the plan year (or earlier termination of participation) and any grace period and/or run-out period, any remaining unreimbursed funds not subject to a carryover provision must be forfeited to the plan
  - No option for employers to make exceptions—that would risk all employee elections becoming taxable

Permitted Use of Experience Gains from Forfeitures

- The Section 125 regulations generally provide the following permitted plan uses of experience gains resulting from forfeitures:

1) To reduce required salary reduction amounts for the immediately following plan year, on a reasonable and uniform basis;
2) Returned to employees on a reasonable and uniform basis; or
3) To defray expenses to administer the cafeteria plan.

- **Additional Notes:**
  - Refunding employees for their specific remaining unreimbursed balance is not permitted
  - Employers almost always apply experience gains from forfeitures to the FSA administrative expenses
  - **For the Health FSA:** Experience gains are the result of annual forfeitures reduced by the health FSA's losses from overspent accounts by employees who terminate mid-year (uniform coverage rule)
  - **For the Dependent Care FSA:** Forfeitures could likely be retained by the employer because ERISA does not apply (ERISA fiduciary duties prohibit this option for health FSA)

Use-It-Or-Lose-It:
General Rule for FSAs

Prop. Treas. Reg. §1.125-1(c)(7):

(7) Operational failure.

(i) In general. If the cafeteria plan fails to operate according to its written plan or otherwise fails to operate in compliance with section 125 and the regulations, the plan is not a cafeteria plan and employees' elections between taxable and nontaxable benefits result in gross income to the employees.

(ii) Failure to operate according to written cafeteria plan or section 125. Examples of failures resulting in section 125 not applying to a plan include the following—

(A) Paying or reimbursing expenses for qualified benefits incurred before the later of the adoption date or effective date of the cafeteria plan, before the beginning of a period of coverage or before the later of the date of adoption or effective date of a plan amendment adding a new benefit;

(B) Offering benefits other than permitted taxable benefits and qualified benefits;

(C) Operating to defer compensation (except as permitted in paragraph (o) of this section);

(D) Failing to comply with the uniform coverage rule in paragraph (d) in §1.125-5;

(E) Failing to comply with the use-or-lose rule in paragraph (c) in §1.125-5;

(F) Allowing employees to revoke elections or make new elections, except as provided in §1.125-4 and paragraph (a) in §1.125-2;

(G) Failing to comply with the substantiation requirements of § 1.125-6;

(H) Paying or reimbursing expenses in an FSA other than expenses expressly permitted in paragraph (h) in §1.125-5;

(I) Allocating experience gains other than as expressly permitted in paragraph (o) in §1.125-5;

(J) Failing to comply with the grace period rules in paragraph (e) of this section; or

(K) Failing to comply with the qualified HSA distribution rules in paragraph (n) in §1.125-5.

Use-It-Or-Lose-It:
Exceptions to the Rule

There are two main exceptions to the general rule that FSA participants forfeit contributions for which the participant has not incurred eligible expenses by the end of the FSA plan year. There are advantages/disadvantages and important limitations for each.

Exception #1:
Grace Period

Optional Health FSA or Dependent Care FSA provision that permits participants to incur claims 2½ months after the end of the plan year

- The grace period is **optional**
- *Must check the cafeteria plan document to confirm whether it is available*
- For a calendar plan year, grace period permits FSA participants to incur expenses until March 15 of year two
- Can be followed by a run-out period (often 90 days) to submit claims incurred by the end of the grace period

Exception #2:
$500 Carryover

The Health FSA may offer the ability to carry over up to $500 into subsequent plan years

- For the health FSA only—not permitted under the dependent care FSA
- The $500 carryover is **optional**
- *Must check the cafeteria plan document to confirm whether it is available*
- **Advantage:** Not limited to 2½ months
- **Disadvantage:** Limited to $500
- Cafeteria plan can provide grace period for dependent care FSA and carryover for health FSA (this is common)

Health FSA:
Mid-Year Termination of Participation

Employees who lose eligibility for the Health FSA mid-year because of a termination of employment or reduction in hours will be faced with the use-it-or-lose-it rule earlier than ongoing employees. They have two options to access unreimbursed contributions.

Option #1:
Run-Out Period

Most cafeteria plans provide for a run-out period to submit FSA claims incurred prior to termination

- Typically this period is 90 days—but must check the plan document to confirm
- Plan may provide that health FSA coverage (i.e., the ability to incur reimbursable claims) continues through the end of the month in which the employee terminates (similar to many medical/dental/vision plans)
- Run-out period will begin whenever health FSA coverage ends

Option #2:
COBRA

Coverage for an underspent health FSA can be continued via COBRA through the end of the plan year in which the employee terminates

- An account is underspent if the employee contributed more to the FSA than had been reimbursed at the time of the COBRA qualifying event
- COBRA permits the employee to incur reimbursable claims for the remainder of the plan year
- If the health FSA has the $500 carryover, COBRA can continue for 18 months

Health FSA:
Mid-Year Termination of Participation

Sample Language: Summary of Options to Provide Employees

The company's health FSA is a component of company's cafeteria plan, which is governed by Internal Revenue Code §125. The Section 125 regulations provide that company must follow the written terms of its cafeteria plan document to maintain the tax-advantaged status of employees' health FSA elections.

Upon terminating employment, you lost coverage under the company's health FSA. However, there are two options available to you to access unreimbursed funds remaining in the company's health FSA at the time of your termination:

- ***Option #1: Run-Out Period***

  The company's cafeteria plan provides a 90-day run-out period [CONFIRM IN PLAN DOCUMENT] for terminated employees to submit claims incurred prior to termination. You must follow the plan's procedures to properly submit any outstanding claims within that run-out period.

  At the end of the run-out period, the use-it-or-lose-it rule for health FSAs requires that any unreimbursed funds be forfeited to the plan unless you elect COBRA (see Option #2 below).

- ***Option #2: COBRA Continuation Coverage***

  Upon terminating from employment, you experienced a COBRA qualifying event to continue coverage under the company's health FSA through the end of the plan year. This option will be available to you only if your account was underspent at the time of termination (i.e., you had contributed more than you had been reimbursed at the time of the qualifying event).

  If you timely elect and pay for COBRA continuation coverage under the health FSA, you will be able to continue incurring claims for reimbursement through the end of the plan year. Up to $500 remaining in your health FSA at the end of the plan year will be subject to the plan's carryover provision and may continue to be available for the duration of your maximum COBRA period (18 months from termination). [DELETE LAST SENTENCE IF THE PLAN DOES NOT OFFER CARRYOVER]

Dependent Care FSA:
Mid-Year Termination of Participation

Employees who lose eligibility for the Dependent Care FSA mid-year because of a termination of employment or reduction in hours will face the use-it-or-lose-it rule earlier than ongoing employees. They have two options to access unreimbursed contributions.

Option #1:
Run-Out Period

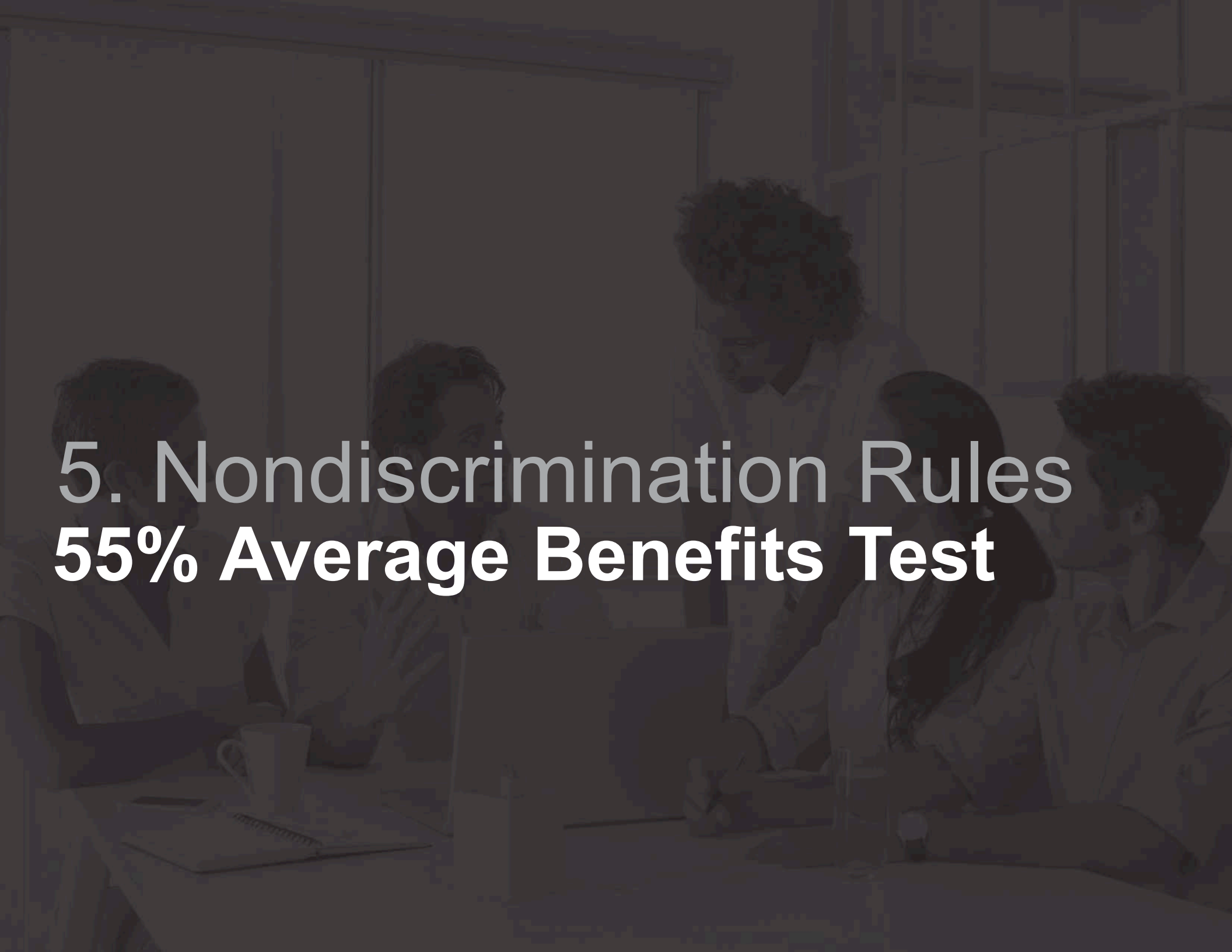
Most cafeteria plans provide for a run-out period to submit FSA claims incurred prior to termination

- Typically this period is 90 days—but must check the plan document to confirm
- Plan may provide that dependent care FSA coverage (i.e., the ability to incur reimbursable claims) continues through the end of the month in which the employee terminates (similar to many medical/dental/vision plans)
- Run-out period will begin whenever dependent care FSA coverage ends

Option #2:
Spend-Down Provision

Allows the terminated participant to incur expenses through the end of the plan year (i.e., spend it down)

- The spend-down provision is **optional**
- *Must check the cafeteria plan document to confirm whether it is available*
- Many dependent care FSAs do not include the spend-down provision
- The option is designed to address the issue of underspent dependent care FSAs because they are not subject to COBRA
- COBRA applies to the health FSA, but not the dependent care FSA



5. Nondiscrimination Rules
55% Average Benefits Test

Nondiscrimination Rules:
Three Main Sets of Tests

Standard cafeteria plans that include a Premium Only Plan (POP), Health FSA, and Dependent Care FSA are subject to three sets of nondiscrimination tests.

A

Section 125 Cafeteria Plan Testing (POP)

- Eligibility Test
- Contributions and Benefits Test
- Key Employee Concentration Test

B

Section 105(h) Health FSA Testing

- Eligibility Test
- Benefits Test

C

Section 129 Dependent Care FSA Testing

- Eligibility Test
- Contributions and Benefits Test
- More-Than-5% Owner Concentration Test
- 55% Average Benefits Test

Nondiscrimination Rules:
55% Average Benefits Test

Dependent Care FSA: 55% Average Benefits Test

- Although this is only one component of the three main tests, it is generally the only one that ever becomes an issue when performing NDT
  - Practical reality is this is the only component of the NDT that employers worry about
  - Nevertheless, employers must still perform all of the NDT from the prior slide to confirm passing result
- The test requires that at least 55% of the dependent care FSA benefits are for non-highly compensated employees (non-HCEs)
  - This is a very hard test to pass without adjustments to HCE elections

Who Qualifies as a Highly Compensated Employee (HCE)?

- **More-than-5% owners of the employer in the current or preceding plan year**
  - Refers to stock ownership for corporations, capital or profits interest for partnerships and other non-corporate entities
  - Attribution applies to family members such as spouses, parents, children, grandchildren
- **Employees who earned in excess of $120,000 in the prior year**
  - Increases to $125,000 for calendar plan years testing in 2020 (based on 2019 compensation)
  - Employees hired mid-year in the prior year may have annualized salary in excess of $120,000, but still not qualify as HCE because they did not earn $120,000 in the partial year of employment
  - Generally look to Box 1 of the Form W-2 to determine compensation level for prior year
  - Section 125 NDT rules say to use current-year compensation for employees hired in the current year, but not clear whether this special current-year-hire rule applies to this dependent care FSA testing

Nondiscrimination Rules:
55% Average Benefits Test

Alternative HCE Testing Method: Top-Paid Group Election (Top 20%)

- Top-paid group election is an option to consider where the dependent care FSA is not passing the 55% Average Benefits Test
- HCE status is determined by whether employees are in the top 20% highest-paid employees
  - Means that HCEs are not determined by a specific compensation level ($120,000 becomes irrelevant)
- Can result in significantly fewer employees meeting HCE status
  - Employees who earned $120,000+ in the prior year but are not in the top 20% are no longer HCEs
  - The more non-HCEs you have, the better the chance to pass the 55% Average Benefits Test

Important Limitation: Must Also Apply to 401(k) Plan

- The top-paid group election cannot be used for the dependent care FSA NDT unless it is also applied to the employer's retirement plans, including any 401(k) plan
  - Employers seeking to utilize the top-paid group election must coordinate with 401(k) nondiscrimination testing vendor to confirm that a top-paid group election is in place for that plan year
- Relevant Cite
  - Treas. Reg. §1.414(q)-1, Q/A-9(b)(2)(iii)

(iii) Method of election. The elections in this paragraph (b)(2) must be provided for in all plans of the employer and must be uniform and consistent with respect to all situations in which the section 414(q) definition is applicable to the employer. Thus, with respect to all plan years beginning in the same calendar year, the employer must apply the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans. If either election is changed during the determination year, no recalculation of the look-back year based on the new election is required, provided the change in election does not result in discrimination in operation.

Nondiscrimination Rules:
Failing the 55% Average Benefits Test

Pre-Test Early! (Before Q4 if Possible)

- The NDT rules look to the last day of the plan year to determine whether the plan passes
- A mid-year pre-test will determine whether the plan will pass on the last day of the plan year
  - For example, test might show a failing result at 45% that requires a 20% reduction to HCE elections
  - That would require an HCE who elected $5,000 to be capped at $4,000 instead
  - Reducing HCE elections ensures that the plan will pass the test as of the last day of the plan year
- The earlier you test, the more likely HCEs have not already exceeded the reduced cap
  - Where the HCE has already exceeded the reduced cap, the employer must recharacterize the excess contributions as taxable income before the end of the year to pass as of the last day of the plan year
  - Far simpler to correct before the HCE reaches the reduced cap by stopping HCEs' contributions at the reduced amount indicated by the pre-test (i.e., payroll cap on contributions for HCEs)

Must Correct By the End of the Plan Year to Pass

- Once the plan year closes, there is no option to correct because the plan will have failed as of the last day of the plan year
  - Cannot wait until January's Form W-2 preparation to address—must recharacterize any excess HCE contributions as taxable income through payroll by the last day of the plan year
- Where employer fails to make corrections by the end of the plan year, the entire dependent care FSA contributions for all HCEs must be recharacterized as taxable income
  - In other words, if the HCE elections are reduced to "0" and the entire contribution amount is taxable
  - The Form W-2 would reflect "0" in Box 10 for dependent care benefits (moved to Box 1 income)

Nondiscrimination Rules:
Failing the 55% Average Benefits Test

Can Employers Prevent Testing Failures?

- **Option 1: Permit Only Non-HCEs to Participate**
  - Test will of course always result in at least 55% of benefits elected by non-HCEs (it will be 100%)
  - Needless to say, this isn't very popular among HCEs
- **Option 2: Limit HCE Contributions to Reduced Level**
  - For example, HCEs may elect up to $3,000 (non-HCEs have the standard $5,000 limit)
  - Reduces the likelihood of a testing failure, but not a guarantee (it's just a guessing game)
  - We generally do not recommend this approach because it will always result in one of the following:
  a) HCEs not being able to take full advantage of the maximum permitted pre-tax election; or
  b) Require a slightly smaller correction than would otherwise be required
- **Option 3: Offer an Employer Matching Contribution to Non-HCEs**
  - For example, a dollar-for-dollar matching contribution for non-HCEs of up to $500
  - This will entice greater participation from non-HCEs with dependent care expenses
  - Again doesn't guarantee passing result, but will make it much more likely

What is Best Practice?

- Do not cap HCE elections, but pre-test early to determine any reduced contribution level
- This approach ensures that HCEs have the maximum pre-tax benefit available to them
  - Early pre-tests will generally catch the issue before HCEs have contributed up to the reduced limit
  - Administrative burden is relatively minor where adjustment is simply a payroll contribution cap

Wrap Up
Takeaways

Section 125 Cafeteria Plans:
Top Five Issues for Employers

1

Why Does Section 125 Matter?

- Only a Section 125 cafeteria plan can prevent employees from constructive receipt of taxable cash
- The cafeteria plan prevents employees from being taxed on the available cash compensation that they instead elected direct to non-taxable health and welfare benefits
- Employee pre-tax premium and FSA contributions require a cafeteria plan!

2

Plan Document Requirements

- Must have a written plan document with specific content requirements
- Section 125 cafeteria plans must be adopted, amended, and restated prospectively to be effective (i.e., signed on or before effective date)

3

Making/Changing Elections

- Section 125 imposes very strict rules on when employees are permitted to make their elections and change them mid-year
- Failure to follow can result in the entire cafeteria plan losing its tax-advantaged status, resulting in all elections becoming taxable for employees

Section 125 Cafeteria Plans:
Top Five Issues for Employers

4

The Use-It-Or-Lose-It Rule

- A fundamental rule for FSAs is that they are subject to use-it-or-lose-it
- Employees hate this rule, and there are always requests for exceptions, but employers should not jeopardize plan's tax-advantaged status
- FSA features such as grace periods, $500 carryovers, and spend down provisions can reduce the potential for participant forfeitures
- Section 125 spells out specific permitted uses for FSA experience gains

5

Nondiscrimination Testing

- Three basic categories of NDT:
  - Section 125 Cafeteria Plan (POP)
  - Section 105(h) Health FSA
  - Section 129 Dependent Care FSA
- Practical reality is that the 55% Average Benefits Test component of the dependent care FSA test is the only one that employers fail
  - Conduct early mid-year pre-testing (before Q4) where possible to determine any required reductions to HCE elections well in advance of end of year
  - Top-paid group (Top 20%) election can help pass where available

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Section 125 Cafeteria Plans

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Thank you!

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