



Section 125: Cafeteria Plan Rules

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Agenda

- Introduction to Cafeteria Plans
- Eligibility Rules
- Qualified Benefits
- Contributions
- Participant Elections
- Nondiscrimination Rules

What Is a Cafeteria Plan? >

➤ Cafeteria Plans

A program that offers employees a choice between cash and certain qualified benefits

Plan design

- Many different design options
 - Simple premium-only plans
 - More complex flex plans

Key feature

- Allow employees to choose between taxable cash and non-taxable qualified benefits without adverse tax consequences



Example: Premium-Only Plans

Give employees a choice between taxable salary and qualified benefits

Enables employees to pay for their share of qualified benefits on a pre-tax basis

Group health insurance is most common qualified benefit

May also allow employees to purchase benefits under a flexible spending account (FSA) – health or dependent care



Example: Full Flex Plans

Full Flex
Plans

- Employer makes contributions on behalf of eligible employees
- Employees use employer money (or credits) to buy different qualified benefits
- Employees may also make their own pre-tax contributions for qualified benefits
- May include a cash-out option

➤ Tax Advantages

- | | | |
|----------|---|--|
| Employee | } | <ul style="list-style-type: none">• Salary reduction contributions not subject to federal income or employment taxes = increase in take-home pay |
| Employer | } | <ul style="list-style-type: none">• Reduce tax liability |

IMPORTANT: Must offer choice between cash and qualified benefits under a cafeteria plan in order to avoid tax problems

Basic Section 125 Requirements





Written Plan Document

Every cafeteria plan must have a written plan document

- Must be formally adopted by employer on or before the first day of plan year
- No cafeteria plan document = adverse tax consequences
- Benefits that are funded under cafeteria plan may also need plan document (separate documents or sometimes combined)

Plan Document Contents

Cafeteria plan document should address:

- Description of available benefits
- Participation rules
- Election procedures
- Manner of contributions
- Maximum contribution amount for each benefit
- Plan year
- Specific provisions for available benefits

➤ Nondiscrimination Rules

Cafeteria plans must pass three nondiscrimination tests:

Eligibility to participate

Benefits and contributions

Key employee concentration

Tests are designed to ensure the plan does not discriminate in favor of highly compensated individuals



Reporting and Disclosure

Form 5500

- Not required for cafeteria plans
- ERISA benefits offered under cafeteria plan are subject to reporting (unless an exception applies)

Disclosure

- No participant disclosure requirements for cafeteria plans
- Disclosure requirements may apply to cafeteria plan's benefit components

Eligibility Rules >



Who Can Sponsor?

Any employer with employees subject to U.S. income tax can sponsor a cafeteria plan

Private sector employers

Nonprofit entities

Governmental employers

Partnerships, LLCs and S-corporations

➤ Who Can Participate?

Only employees can participate in a cafeteria plan

Employees

- Includes current and former common law employees (for example, COBRA beneficiaries)
- Does not include self-employed individuals (for example, partners in a partnership)
- Non-employee directors cannot participate

➤ Coverage for Spouses and Dependents

Can only offer qualified benefits to employees, spouses, dependent children and tax dependents

Who Is a Spouse?

- All legally married spouses

Who Is a Dependent Child?

- An employee's child who is under age 27 at the end of taxable year

Who Is a Tax Dependent?

- "Qualifying child" or "qualifying relative" under Internal Revenue Code

Qualified Benefits >

Qualified Benefits

Benefits that may be offered under a cafeteria plan

- Accident or health plan coverage (HMO, PPO, HDHP, etc.)
- Accidental death and dismemberment (AD&D) coverage
- Adoption assistance benefits
- COBRA coverage (if participant has compensation that can be used to pay for COBRA pre-tax)
- Dependent care assistance benefits
- Dental benefits
- Disability benefits (short-term or long-term coverage)
- Health FSA contributions
- Health savings account (HSA) contributions
- Group-term life insurance coverage (on employee's life)
- Vision benefits

Non-Qualified Benefits

Benefits that cannot be offered under a cafeteria plan

- Educational assistance plans
- Employer-provided meals and lodging
- Fringe benefits
 - Transportation fringe benefits
 - Moving expense reimbursements
 - Retirement planning services
- Health reimbursement arrangements (HRAs)
- Individual medical insurance policies (non-Exchange policies are permitted in 2020 under new rules for individual coverage HRAs)
- Life insurance on spouse's or dependent's life
- Long-term care insurance or services
- Pet insurance

Contributions >

➤ Cafeteria Plan Contributions

Cafeteria plan benefits can be funded in a variety of ways

Employee contributions

- Employees reduce salary on a pre-tax basis to pay for benefits
- Not subject to federal income or employment taxes

Employer contributions

- Employer may contribute toward cost of benefits via:
 - Fixed amount for specific benefits
 - Matching contributions
 - Flex credits

Amount of Contributions

May vary from benefit to benefit

- Plan design preferences
- Legal restrictions for certain benefits (for example, health FSAs)

May vary for different groups of employees

- Concern is nondiscrimination rules

Cash-out Provisions

- **Cash-out (or opt-out):** Cash incentive to waive a qualified benefit (for example, health insurance)
- **Potential Legal Issues:**
 - Under ACA, cannot condition on purchase of individual policy
 - May impact affordability calculation under pay or play rules for ALEs
 - HIPAA nondiscrimination
 - Medicare secondary payer
 - Insurance contract terms

Opt-out incentives must be offered under a cafeteria plan to avoid adverse tax consequences

Participant Elections >

➤ General Rules

Timing

- Elections must be made **in advance** on a prospective (not retroactive) basis
- Annual open enrollment period
- Mid-year enrollment window for new hires or permitted mid-year election changes
- Narrow exception for certain HIPAA special enrollment events

Voluntary

- Elections must be **voluntary**
- Must be a choice between taxable benefit and qualified benefits
- Some employers offer choice between pre-tax and after-tax benefits

Types of Elections

Affirmative Elections

- Most common and straightforward method
- Employees complete written agreement authorizing cafeteria plan elections

Automatic Elections

- Employees who do not want to participate must complete waiver
- Employers must provide adequate notice to employees

Rolling Elections

- Current elections continue to next plan year unless employee files a new election
- Should be disclosed in the initial election form
- Not popular with full flex plans and FSAs

Selecting an election method should involve a number of factors—for example, plan design, employer preference, workforce demographics, and state laws

➤ Irrevocable Elections

Participants' elections are **irrevocable** during the plan year

Subject to certain limited exceptions

IRS recognizes certain circumstances that permit mid-year election changes

Plan design option—not required to allow participants to change elections

Most employers design their cafeteria plans to allow the mid-year election changes permitted by IRS

➤ Mid-Year Election Changes

IRS recognizes three broad categories of mid-year election changes

- Change in status
 - Major life events (marriage, birth, adoption, employment changes)
- Cost or coverage changes
 - Changes to qualified benefits under cafeteria plan
- Other laws or court orders
 - Coordinate cafeteria plan rules with other laws (for example, HIPAA, COBRA and ACA)

General Rules

For an employee to be eligible to change his or her election during a plan year:

- Employee must experience a mid-year election change recognized by IRS
- Cafeteria plan must permit mid-year election change
- For change in status events, the requested election change must be consistent with the change in status event



Change in Status Events

Major life events that impact eligibility for coverage

Change in marital status

Change in number of dependents

Change in employment status

Change in residence

Dependent is no longer eligible

Cost Changes

Cost Changes – Automatic

- May automatically increase or decrease employees' contributions if:
 - The cost of a benefit changes during a period of coverage; and
 - Employees are required to make a corresponding change in their payments.

Significant Cost Changes– Employee Election

- May permit mid-year election change if the cost charged to an employee for a qualified benefit significantly increases or decreases during a period of coverage

➤ Coverage Changes

Coverage changes

- Significant curtailment of coverage
- Addition or improvement of benefit package option
- Change in coverage of spouse or dependent under another employer plan
- Loss of certain other group health coverage (including CHIP coverage)



Other Laws/Court Orders

| Event | Description |
|----------------------------------|---|
| HIPAA Special Enrollment | Changes that correspond with HIPAA special enrollment events |
| COBRA Qualifying Event | Increase contributions to pay for COBRA coverage |
| Judgments, Decrees, or Orders | Change coverage for a dependent child based on legal judgment, decree, or order |
| Medicare or Medicaid Entitlement | Change coverage election due to Medicare or Medicaid entitlement (or loss of entitlement) |
| FMLA Leave | Change coverage election when taking FMLA leave |

› ACA Changes

Exchange enrollment

- Employee wants to end coverage under employer's group health plan and purchase coverage through an Exchange

Reduction in hours of service

- Employee's hours are reduced to fewer than 30 hours of service per week, but the reduction does not affect eligibility for coverage under the employer's group health plan

Special Rules

- Only some of the mid-year election changes apply to health FSAs
 - Change in status events apply
 - Cost and coverage changes do not apply
 - ACA changes do not apply
- Employees can prospectively change their HSA contribution elections at any time during the plan year

Nondiscrimination Rules



» Three Main Tests

Eligibility Test

- Sufficient number of non-highly compensated individuals must be eligible to participate in the plan

Benefits and Contributions Test

- Contributions and benefits must be available on nondiscriminatory basis
- Test looks at availability and utilization
- Plan must also be nondiscriminatory in operation

Key Employee Concentration

- Key employee contributions cannot exceed **25 percent** of the total contributions into the plan

➤ Core Concepts

- ✓ The nondiscrimination tests are complex
 - Most employers use outside service provider to perform
- ✓ Testing should be performed each plan year
 - If performed early, may be able to make adjustments to ensure compliance
- ✓ If plan is discriminatory, benefits for highly compensated individuals are taxed



Simple Cafeteria Plans

Safe harbor plan design for small employers (100 or fewer employees)

Eligibility requirement

- All employees with at least 1,000 hours of service are eligible to elect any available benefit

Employer contribution

- Employer must contribute, regardless of whether employees make salary deferrals
- Required contribution amounts

Safe harbor design

- Automatically pass three cafeteria plan tests and tests for certain component benefits



Separate Nondiscrimination Tests

Additional nondiscrimination tests apply to certain qualified benefits

Health FSA

- Code §105(h) rules for self-insured medical plans

Group term life insurance

- Code § 79 nondiscrimination rules

Dependent care FSA

- Code § 129(d) nondiscrimination rules

Questions? 

Thank you! 

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