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Cafeteria Plans 101: The Basics, Mid-Year Election Change Rules and Nondiscrimination Testing

Presentation for:
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Michelle concentrates her practice in the areas of health and welfare plans, qualified retirement plans, and executive deferred compensation plans.

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Tyler concentrates his practice in the areas of executive compensation and employee benefit arrangements.

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- **Corporate Representation**: Advises private and publicly-traded clients and their boards of directors on compensation and benefits matters, including:
  - -Drafting CD&As
  - -Drafting and maintaining equity and synthetic equity plans
  - -Advising pre-IPO companies on their compensation arrangements
  - -Preparing documents for the hiring and firing of key employees
  - -Drafting executive agreements
  - -Designing and drafting compensatory profits interests for partnerships and LLCs taxed as a partnership
- **Transactions**: Advises clients on compensation and benefit issues associated with corporate transactions, including:
  - -Tailoring of transaction documents
  - -Performing Section 280G analyses and associated benchmarking
  - -Designing change-in-control bonus plans, management carve-out agreements and other retention arrangements
  - -Drafting option cancellation/assumption agreements and inducement plans
  - -Addressing incentive and retention issues
- **Section 409A**: Helps clients comply with all aspects of Section 409A and its application to traditional non-qualified deferred compensation arrangements, equity plans, employment and severance arrangements, bonus arrangements and reimbursement arrangements.

Upcoming 2022 Webinars

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- **Upcoming 2022 webinars**:
  - **November 17:** End of Year Benefits "To-Do" List
  - Sign up here: **Employee Benefits Academy Webinar Series - Subscribe**

Section 125 Plans – The Big Picture

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- A Section 125 Plan 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 Section 125 Plan – Employees must include in income any amount which they actually or constructively receive
    - Means that, without a Section 125 Plan, an employee's election between taxable income (including cash) and nontaxable benefits results in taxable income to the employee
  - With a Section 125 Plan – Employees avoid constructive receipt
    - Allows employees to make a choice between taxable cash income and nontaxable benefits and not be taxed if they elect the nontaxable benefit

Section 125 Plans – Qualified Benefits

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- Only qualified benefits can be part of a cafeteria plan, including:
  - Group Health Plan (Medical, Dental, Vision)
  - Health FSA, Dependent Care FSA
  - HSA
  - Group Term Life ($50k coverage cap without imputing income on the value of the coverage)
  - AD&D
  - Hospital Indemnity/Cancer Insurance
  - Disability (generally either contributions or benefits are taxable depending on whether premiums are paid on a pre-tax or after tax basis)
  - 401(k) Plan (cash flex credits, uncommon)
  - Adoption Assistance (no FICA exemption, uncommon)
  - PTO Buying/Selling (uncommon)

Plan Document – Timing & Content Requirements

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Retroactive Adoption, Amendment or Restatement Prohibited

- Cafeteria plans must be evidenced by a written plan document
- The plan document must be signed (adopted) on or before the date that the plan becomes effective
- If an employer implements a cafeteria plan without a written plan document in place the IRS could find that the cafeteria plan is invalid, resulting in all employee health and welfare premiums and FSA pre-tax elections becoming taxable to employees, as well as under withholding by the employer

Plan Document – Content Requirements

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- The Section 125 regulations provide that the written plan document must include:
  - A specific description of each of the benefits available through the cafeteria plan, including the periods of coverage
  - The plan's rules governing participation (only employees and former employees may participate; self-employed individuals are not eligible)
  - 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
  - The maximum amount of elective contributions available
  - 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 any)

Making and Changing Elections

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- 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:
    - Made prior to the start of the plan year; and
    - Irrevocable for the duration of the plan year (generally, a 12-month period) unless the employee experiences an election change event, that is permitted under the Section 125 rules, as well as under the terms of the plan

Making and Changing Elections

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- Consequences of failing to follow the irrevocable election requirement
  - If an employer's cafeteria plan were to permit employees to make mid-year election changes without experiencing a permitted election change event, the plan would violate the irrevocable election rule
    - The Section 125 rules provide that the IRS could cause the entire cafeteria plan to lose its tax-advantaged status if discovered on audit, resulting in all elections becoming taxable for all employees, as under withholding by the employer

Making and Changing Elections During Open Enrollment

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- 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
  - It is permissible (but not required) to allow employees to make elections all the way up to the last second before the start of the new plan year; however, employers may establish more restrictive open enrollment periods for administrative purposes

Prohibition of Deferred Compensation

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- General Rule – A cafeteria plan may not permit employees to defer compensation to a future year
- Results in the "use it or lose it" rule for FSAs (i.e., amounts may generally not be carried forward to future years)
- Exceptions to prohibition of deferred compensation:
  - 401(k) plan deferrals (although permitted, 401(k) plans are rarely included in cafeteria plans in practice)
  - Contributions to HSAs

Prohibition of Deferred Compensation

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- Exceptions to prohibition of deferred compensation (cont.)
  - FSA grace period
    - Allows unused healthcare or dependent care FSA dollars to be used for expenses incurred in the first 2 ½ months of the next plan year
  - Health care FSA carryover
    - Allows up to $550 (in 2020 and indexed annually) to be carried over and use to pay expenses incurred in the next plan year
- Note that a cafeteria plan may have a grace period provision or a carryover provision, but not both

Making/Changing Elections: Mid-Year Election Changes – Annual Rules

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- Employers do not have to include all (or any) permitted election change events in a cafeteria plan
- However, most employers allow all of the permitted election change events to assist employee needs
- Most cafeteria plans require employees to request a mid-year election change within 30 days from the date of the permitted election change event
  - Administrative convenience
  - Helps insure "consistency" requirement is satisfied

Making/Changing Elections: Status Change Events

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- Status Change Events
  - This is the broadest and most widely used category of permitted election change events
  - Generally requires that the election change be on account of and correspond with the event – commonly referred to as the "consistency rule"

Making/Changing Elections: Status Change Events

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- Status changes include:
  - Change in employee's marital status (i.e., marriage, divorce, death of spouse, legal separation, and annulment),
  - Change in the number of dependents (i.e., birth, adoption, placement for adoption, death),
  - Change in employment status(i.e., termination, commencement, strike/lockout, termination of or return from unpaid leave, change in worksite or change in employment status affecting eligibility),
  - Dependents satisfying or ceasing to satisfy dependent eligibility requirements,
  - Change in residence, and
  - Commencement or termination of adoption proceedings.
- The plan document must include a provision for each of the above events the employer wishes to allow.

Making Changing Elections: Status Change Events

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- Consistency Requirement
  - If a change in status event occurs, a plan can only permit employees to make election changes that are consistent with the event.
  - The change in status event must affect eligibility for coverage under the cafeteria plan or a component plan under the cafeteria plan.
    - For example, a change in marital status (marriage or divorce) affects the eligibility of the new (or former) spouse
  - If one type of coverage is lost/gained, then the election change must be limited that type of coverage.
  - If an employee was not previously enrolled and a change in status occurs which would allow the employee to cover a dependent (e.g., birth of a child), this rule allows the employee to enroll in order to enroll the dependents.
  - Other eligible individuals can also be added when a spouse or dependent gains eligibility as a change in status event.

Making/Changing Elections: Significant Cost Changes

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- If the cost of a benefit option under a cafeteria plan significantly increases or decreases, a plan may permit a mid-year election change.
- If costs significantly increase, participants may change to a less costly option providing similar coverage or drop coverage if there is not a similar option to switch to.
- If the cost of an option significantly decreases, participants may commence participation in that option even if they had not previously enrolled in any coverage.
- This rule applies to all qualified benefits except Health Care FSAs.

Making/Changing Elections: Significant Curtailment of Coverage

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- If the coverage of an option is significantly decreased (e.g., a significant increase in the deductible, copay or out-of-pocket cost sharing provisions), participants may change to a similar option available under the plan.
- The election can be revoked if no other benefit option providing similar coverage is offered.
- This rule applies to all qualified benefits except Health Care FSAs.

Making/Changing Elections: Addition or Significant Improvement of Benefit Plan Option

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- Participants can elect newly offered or significantly improved benefits on a prospective basis whether or not they previously made an election under the cafeteria plan.
- Applies to all qualified benefits except Health Care FSAs.

Making/Changing Elections: Change in Another Employer's Coverage

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- Occurs when another employer's plan covering a spouse or dependent of the employee allows an election change consistent with the regulations or has a different period of coverage.
- The election change must be on account of and correspond with the change under the plan of the spouse or dependent (e.g., enrollment by a spouse or dependent in the other employer's plan).

Making/Changing Elections: COBRA Qualifying Events

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- A cafeteria plan may permit an employee to make a mid-year election change if a COBRA event occurs to the employee, spouse or dependent.
- If still employed, employee may increase pre-tax salary reductions to cover the COBRA premiums.

Making/Changing Elections: Orders, Decrees, Judgments

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- A cafeteria plan may allow mid-year changes on account of court orders resulting from divorce, legal separation, annulment, or change in legal custody.
- Example:
  - An employer receives a qualified medical child support order (QMCSO) requiring the employee to cover a dependent child.
  - The employee is allowed to change his election in order to cover the child.
- Note that a cancellation of coverage is permitted only if the order requires the employee's spouse, former spouse of other individual to provide coverage for the child, and such coverage is actually provided.

Making/Changing Elections: Entitlement to Medicare or Medicaid

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- A cafeteria plan may allow mid-year election changes on account of eligibility of the employee, spouse or dependent for Medicare or Medicaid.
- Gaining Medicare or Medicaid allows the participant to cancel or reduce health coverage under the plan.
- Losing Medicare or Medicaid allows the participant to elect or increase coverage under the plan.

Making/Changing Elections: FMLA Leave

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- A cafeteria plan may allow a mid-year election change on account of a leave of absence under the FMLA.
- Employer must allow all election changes otherwise available to employees on non-FMLA leave.
- The plan must allow participants to revoke health care coverage during the FMLA leave, and to reinstate coverage upon returning from the FMLA leave.
- If employee continues coverage during an FMLA leave, employer may allow three types of payment options: pre-pay, pay-as-you go, or catch-up upon return from the leave.
- This rule applies to health care FSAs.

Making and Changing Elections: HIPAA Special Enrollment

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- 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
- Upon experiencing a HIPAA special enrollment event, the plan is required to allow the employee to select any medical benefit option available under the plan.
- 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 (60-day election period for loss of Medicaid/CHIP eligibility).

Making/Changing Elections: HIPAA Special Enrollment Events

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- 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 must 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 must be effective no later than June 1.*

Making/Changing Elections: HIPAA Special Enrollment Events

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- Birth/Adoption: Coverage Retroactive to the Date of the Event
  - If an employee gains 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.

    – ***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 (i.e., the date of birth)*

Making/Changing Elections: HIPAA Special Enrollment Rights

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- 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

Health FSAs: Summary of Permitted Mid-Year Election Change Events

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Change Permitted	No Change Permitted
• Change in Status Event	• Significant Cost Changes
• Judgments, Decrees, or Orders	• Significant Coverage Curtailment
• Medicare or Medicaid Entitlement	• Addition or Significant Improvement of Benefit Package Option
• FMLA Leaves of Absence	• Change in Coverage Under Other Employer Plan
• COBRA Qualifying Events	• Loss of Group Health Coverage Sponsored by Governmental or Educational Institution
	• Pre-Tax HSA Contribution Changes
	• Exchange Enrollment

Making/Changing Elections: Exceptions Not Recommended

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- Employees sometimes request mid-year election changes even though they haven't experienced a permitted election change event. There are at least three reasons for not allowing exceptions.
- Reason 1: Wholesale failure to adhere to the permitted election change event rules can cause the entire cafeteria plan to lose its tax-advantaged status
- Reason 2: Insurance carriers (and stop-loss providers) generally will pay claims only for employees and dependents who are eligible and properly enrolled
  - If a carrier discovers that an employee was allowed to enroll in any other situation, the carrier might deny paying all claims for that employee/dependent, making the employer responsible for self-funding all claims

Making/Changing Elections: Exceptions Not Recommended

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- Reason 3: ERISA Plan Precedent
  - ERISA requires that employers administer the plan consistently and in accordance with the terms of the written plan document
    - The 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
    - If the employer makes an exception, it is arguable that the employer has effectively interpreted the plan's terms to permit the exception, and this interpretation should be applied consistently for all similarly situated employees

Making/Changing Elections: Doctrine of Mistake

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- 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. Facts and circumstances must be compelling to qualify for this exception. The presumption is that the employee has just changed his/her mind.
- 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 in only very rare circumstances like these that an employee could change or revoke an existing election without experiencing a permitted election change event

Nondiscrimination Testing

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- Cafeteria plans that include a premium only plan, health FSA and dependent care FSA are subject to three sets of discrimination tests
  - Cafeteria Plan Testing (POP)
  - Section 105(h) Health FSA Testing
  - Section 129 Dependent Care FSA Testing

Section 125 Cafeteria Plan Testing

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- Eligibility Test
  - Employment Requirement: the new-hire waiting period must apply to all employees and cannot be longer than three years;
  - Entry Requirement: employees must be eligible immediately following the waiting period; and
  - Non-discrimination Requirement: the plan must ensure it does not discriminate in determining who benefits from the plan.
  - Safe Harbor Test: an employer can pass the eligibility test automatically if all employees are eligible to participate in the plan, all employees have the same waiting period and the waiting period is less than 3 years.

Section 125 Cafeteria Plan Testing

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- Contributions and Benefits Test
  - Availability: similarly situated employees must be given the same opportunity to elect benefits;
  - Utilization: tax-free benefits available to highly compensated employees need to compare favorably with the tax-free benefits of the non-highly compensated employees;
  - Non-discrimination: the plan must ensure it does not discriminate in practice.
- Key Employee Concentration Test
  - Key employee benefits under the plan cannot be more than 25% better than all employees' benefits under the plan.
- Failure to meet the nondiscrimination requirements will reduce or eliminate the tax-free status of the benefits.

Section 105(h) Health FSA Testing

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- Section 105(h) of the Internal Revenue Code generally excludes from gross income amounts paid through employer-sponsored health coverage.
- This exclusion may not apply to benefits provided to **highly compensated individuals** ("HCIs") under a self-insured plan if the plan discriminates in favor of these individuals in terms of benefits or eligibility (as defined in Section 105(h).
- ACA has made fully-insured plans subject to rules "similar" to those that apply to self-insured plans. However, the Treasury Department announced a delay in the enforcement of the nondiscrimination rules against fully-insured (non-grandfathered) group health plans until it issues further guidance.

Section 105(h) Health FSA Testing

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- Eligibility Test: A plan will pass if it meets any one of three alternative tests:
  - 70% Test: Must demonstrate that the plan benefits 70% or more of all nonexcludable employees
  - 70%/80% Test: Must demonstrate that 70% of all nonexcludable employees are eligible to benefit and 80% of those eligible actually do benefit under the plan. In this context, to "benefit" means to actually participate in the plan.
  - Nondiscriminatory Classification Test: The plan benefits a nondiscriminatory group (classification) of employees. This requires:
    - bona fide business classifications for any exclusions (a subjective component), and
    - a sufficient ratio of benefiting non-HCIs to benefiting HCIs (an "objective"component)

Section 105(h) Health FSA Testing

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- Contributions and Benefits Test
  - A plan will pass the benefits test if:
    - All benefits provided to highly compensated participants under the plan are provided to all other participants. Must be the same type and amount of benefit; and
    - The plan does not discriminate in actual operation. This tests the benefits available to employees, not actual utilization of those benefits.

Section 129 Dependent Care FSA Testing

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- Eligibility test – the DCAP must benefit employees who qualify under an eligibility classification that does not discriminate in favor of highly compensated employees.
- Contributions and benefits test – the contributions or benefits provided under the DCAP may not discriminate in favor of employees who are highly compensated employees.
- The "5-percent owner" test – not more than 25 percent of the total benefits under the DCAP can be provided to individuals who own more than 5 percent of stock, capital or profit interest in the employer.
- The "55 percent average benefits" test – the average benefits provided to non-highly compensated employees must be at least 55 percent of the average benefits provided to highly compensated employees

Section 129 Dependent Care FSA Testing

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- 55% Average Benefits Test
  - Although this is only one component of the tests, it is generally the only one that ever becomes an issue
  - Employers must still perform all of the NDTs to confirm passing result

Section 129 Dependent Care FSA Testing

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- 55% Average Benefits Test
  - Requires that at least 55% of the dependent care FSA benefits are for non HCEs
  - Hard test to pass without adjustments to HCE elections
  - Who qualifies as a HCE?
    - More than 5% owners of the employer in the current or preceding plan year.
    - Employees who earned in excess of $130,000 in the prior year (2021) for 2022 testing
      - Increases to $135,000 for calendar plan years testing in 2023 (based on 2022 compensation)

Section 129 Dependent Care FSA Testing

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- 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 the specific annual compensation level under §414(q)

Section 129 Dependent Care FSA Testing

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- Alternative HCE Testing Method: Top-Paid Group Election (Top 20%)
  - Can result in significantly fewer employees meeting HCE status
  - Employees who earned $130,000+ 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

Section 129 Dependent Care FSA Testing

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- Correcting 55% Average Benefits Test Failures
  - 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 pretest 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

Section 129 Dependent Care FSA Testing

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- Correcting 55% Average Benefits Test Failures
  - 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 the pretest (i.e., payroll cap on contributions for HCEs)

Section 129 Dependent Care FSA Testing

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- Correcting 55% Average Benefits Test Failures
  - 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 income through payroll by the last day of the plan year
    - Must recharacterize any excess HCE contributions as taxable
    - Where employer fails to make corrections by the end of the plan year, the entire dependent care FSA contributions for all HCE be recharacterized as taxable income

Section 129 Dependent Care FSA Testing

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- Ways to Prevent Testing Failures
  - Permit only non-HCEs to participate
    - Test will always result in at least 55% of benefits elected by nonHCEs (it will be 100%)
    - Not popular among HCEs
  - Limit HCE contributions to a reduced level
    - Example: HCEs may elect up to $3,000 (non-HCEs have the standard 2022 $5,000 limit)
    - Reduces the likelihood of a testing failure, but not a guarantee
  - Offer an employer matching contribution to non-HCEs
    - 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
    - Doesn't guarantee passing result, but will make it much more likely

Section 129 Dependent Care FSA Testing

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- Failing the 55% Average Benefits Test
  - 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

Key Takeaways

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- A cafeteria plan is the exclusive means by which an employer can offer employees an election between taxable income and nontaxable benefits on a tax-advantaged basis
- Must have a written plan document with specific content requirements
- IRC Section 125 imposes strict rules on when employees are permitted to make their elections, change them mid-year and the period during which their benefits may be used; allowing mid-year election changes is generally permissive; plan must specifically allow for the permitted mid-year election change events
- Don’t overlook nondiscrimination testing
- Violation of the IRC Section 125 rules can result in significant tax consequences

Questions?

Upcoming Webinars

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Executive Compensation Academy

- Title: Compensation Considerations Due to Upcoming Loss of EGC Status
- When: October 13, 2022
- Time: 10:00 am – 11:00 am CT
  11:00 am – 12:00 pm ET

Employee Benefits Academy

- Title: End of Year Benefits “To-Do” List
- When: November 17, 2022
- Time: 10:00 am – 11:00 am CT
  11:00 am – 12:00 pm ET