

2018 Employee Benefits Webinar Series
Back to Basics – Cafeteria Plans 101
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Cafeteria Plan Overview

- Introduction to Cafeteria Plans
- Qualified Benefits
- Written Plan Requirement
- Eligibility for Pre-Tax Benefits
 - Domestic Partner Contributions
- Cafeteria Plan Elections
 - Change in Status Events
- Health Flexible Spending Accounts under the ACA
- Nondiscrimination Rules
- Simple Cafeteria Plans
- Opt-Out Payments
- Correcting Mistakes

Introduction to Cafeteria Plans

- Choices between cash (unreduced compensation) or a qualified benefit (e.g., medical, dental or vision insurance) must be documented as part of a written cafeteria plan
- Cafeteria plans enable employees to pay for part of the cost of their benefits through salary reductions, which reduces their taxable income
 - Employee contributions not subject to federal income tax or employment taxes
 - Could reduce an employee's social security benefit
- Cafeteria plans are subject to § 125 of the Internal Revenue Code
 - Must offer a choice between a taxable benefit (e.g. cash) and at least one non-taxable benefit
 - They are often referred to as Section 125 Plans, Premium Conversion Plans or Flexible Benefit Plans

Qualified Benefits

- Typical benefits available under a cafeteria plan include:
 - Medical
 - Dental
 - Vision
 - Health and Dependent Care FSA contributions
 - Health Savings Account contributions
 - Group Term Life Insurance (on the employee)
 - For amounts over \$50,000, greater of the cost of coverage or the employee's pre-tax contribution is included in gross income
 - Disability (Short and Long Term)
 - Accidental Death and Dismemberment

Benefits Not Available under a Cafeteria Plan

- Benefits not available under a cafeteria plan include:
 - Archer MSAs
 - Athletic facilities
 - De minimis benefits (defined as benefits that are so small that accounting for it would be considered unreasonable or impractical, such as occasional snacks, small gifts, etc.)
 - Employee discounts
 - Employer provided cell phones
 - Lodging on an employer's business premises
 - Educational assistance or tuition reduction.
 - Moving expense reimbursements
 - Transportation/commuting benefits
 - Working condition benefits
 - No additional cost services
 - Retirement planning services
 - Employee meals

Written Plan Requirement

- Failure to maintain a written plan document can result in income inclusion
- Cafeteria plan adoption and amendment generally must be prospective
 - Plan document must include:
 - Description of benefits available under the plan
 - Eligibility rules
 - Election procedures
 - How contributions will be made (e.g., through salary reductions or employer contributions)
 - Maximum amount of participant contributions
 - Plan year
 - SPD not required for cafeteria plan itself, although disclosure requirements may apply to component plans

Cafeteria Plan Eligibility

- In general, cafeteria plans are for employees (W-2 employees)
 - Some plans allow participation by former employees receiving severance (e.g., to pay COBRA)
 - Spouses (same- and opposite-sex) and dependents are eligible for qualified benefits
 - Pre-tax contributions for a domestic partner's coverage are permissible only if the domestic partner is a "qualifying relative" under § 105(b)
 - Dependents include children who are under age 27 at the end of the year, or anyone that qualifies as the employee's "qualifying child" or "qualifying relative" under § 105(b)
- Individuals who are not employees cannot participate
 - Partners in a partnership (paid via form K-1)
 - Members of an LLC
 - Greater than 2% shareholders in an S-corporation
 - Non-employee directors
 - Independent contractors
 - Sole proprietors

Domestic Partner Contributions

A domestic partner is a “qualifying relative” for pre-tax contribution purposes if he or she meets the following requirements:

- i. The domestic partner has the same principal residence as the employee and is a member of the employee’s household;
- ii. The domestic partner’s gross income is less than \$4,050 per year (for 2016 and 2017, as adjusted from year to year);*
- iii. The employee provides over 50% of the domestic partner’s support for the year;
- iv. The domestic partner is a U.S. citizen or lives in the U.S. or a contiguous country; and
- v. The domestic partner is not the dependent child of the employee or of any other person for the same year.

*** The income limit is disregarded when determining whether a domestic partner is a “dependent” for group health plan coverage purposes**

Cafeteria Plan Elections

- Cafeteria plan elections must be made prospectively, prior to the start of the plan year or coverage period (for new hires)
 - Special rule for plans with date-of-hire eligibility allows 30 days for new hires to make an election, with coverage retroactive to date of hire
- Once made, elections are irrevocable unless a permitted election change event has occurred
 - Election change requests must be made within the plan's time limits
 - Employers are not required to adopt all the changes permitted under the regulations, so the cafeteria plan documents should be reviewed carefully to determine whether a change is permitted under the plan as well as under the law
 - Employees must be able to change HSA contributions at least once per month

Cafeteria Plan Election Changes

- HIPAA Special Enrollment Situations
- Changes in Status
- Cost or Coverage Changes
- Judgments, Decrees or Court Orders
- Entitlement to Medicare or Medicaid
- COBRA Events
- FMLA Leave
- Special Rules for Exchange Coverage & Changes to Part-Time

Cafeteria Plan Election Changes

Elections changes for change in status events are permitted only if the proposed change is because of and on account of such event

Election Changes and Spousal “Election Lock”

Rules allow for an election change based on a change in coverage under another employer plan

- Includes a spouse’s, former spouse’s or dependent’s employer’s plan, or another plan of the same employer
- Enables employees and spouses with different open enrollments to coordinate coverage under one plan

Permitted Election Changes

- Contribution election changes are permitted as long as
 - Change is on account of the change made under another plan, and either
 - The election changes are permitted by the other plan, or
 - The plan years for the two affected plans are not the same (“election lock”)

Change due to Exchange Coverage or Move to Part-Time

Two new situations where a cafeteria plan may allow revocation of an election (other than a health FSA election):

- Enrollment in the Exchange
 - Employee must enroll during Exchange open enrollment period or during a special enrollment period; and
 - Employee (and related individuals) must enroll in an Exchange plan effective immediately following the revocation
- Reduction in hours of service
 - Employee must change from FT (30+ hours) to PT status and be reasonably expected to remain PT; and
 - Must enroll in another plan no later than the 1st day of the 2nd full month following the revocation

Changes in Status and Health FSAs

Only some mid-year events allow a change to a health FSA election

- Change in Status events allow a change to a health FSA (e.g., increase health FSA election when adding a spouse or newborn to the group health plan)
- Changes in cost or coverage under an underlying group health plan do not allow a change to a health FSA election (e.g., significant decrease in cost under medical plan does not permit a change to a health FSA election)

Health FSAs under the ACA

- Under the ACA, the employee contribution limit to a health FSA is \$2,500 per year (as indexed, plus the \$500 carryover)
 - Indexed limit for plan years beginning in 2018 is \$2,650 (plus carryover)
 - Limit applies on a controlled group basis, prorated for short plan years
 - Limit applies on a plan year basis; applies to plan, not the employee
 - Employee eligible for health FSAs from different unrelated employers may elect maximum contribution under each employer's plan
- FSAs cannot reimburse over-the-counter medicine and drugs, unless prescribed (or insulin)

Health FSAs under the ACA

- Under the ACA, health FSAs are must be “excepted benefits”
- FSAs will be “excepted” if the employer also offers non-excepted group health plan coverage and the FSA is structured so that the maximum benefit payable cannot exceed the **greater** of:
 - a. 2x the participant’s salary reduction election to the FSA for the year; or
 - b. \$500 plus the participant’s salary reduction election
- If an employer provides a non-excepted FSA, it is subject to the market reforms, including the preventive services requirements
 - Because a non-excepted FSA is not integrated with a group health plan, it will fail to meet the preventive services requirements

Health FSA Carryovers

- Modification to the Use-It-Or-Lose-It Rule for FSAs
 - Can carryover up to \$500 to following plan year
 - Plan cannot have both a grace period and a carryover feature
 - Employers may design FSAs to automatically carry over funds from a general purpose FSA to a limited purpose FSA for employees enrolling in HDHP coverage
- What is more valuable—Grace Period or Rollover?

Health FSA Carryovers and COBRA

- Application of COBRA to FSAs with \$500 Carryover Feature
- General rule: Employers that allow carryovers must also allow them for COBRA participants
 - This could extend COBRA past the end of the plan year
- **However**, an employer may limit the carryover to employees who elect to contribute to the FSA in the following year, in which case COBRA ends at the end of the plan year
- Employers may limit carryovers to a maximum period (e.g., one or more years)

Nondiscrimination Rules for Cafeteria Plans

- The proposed cafeteria plan regulations released in 2007 reinforce that nondiscrimination testing must be performed annually for all cafeteria plans
- Testing must be performed as of the last day of the plan year and must take into account all non-excludable employees (and former employees) who were employed on any day during the plan year

Nondiscrimination Rules for Cafeteria Plans

There are three cafeteria plan nondiscrimination tests:

1. Key Employee Test

- If a plan provides nontaxable benefits to key employees (as defined under Code section 416(i)(1)) in excess of 25% of the aggregate nontaxable benefits provided to all employees through the cafeteria plan, key employees will be taxed on the amounts that have been deducted from their pay on a pre-tax basis
- “Key” employees: an officer with compensation greater than \$175,000 in 2017; a 5% owner of the employer, or a 1% owner with annual compensation greater than \$150,000
 - Key employees generally determined by reference to compensation in prior year
- Certain attribution rules with regard to family members under the 5% and 1% ownership tests.

Nondiscrimination Rules for Cafeteria Plans

There are three cafeteria plan nondiscrimination tests:

2. Eligibility Test

- A cafeteria plan must not discriminate in favor of HCEs as to eligibility to participate. An HCE is any employee who, for the prior year (or current year if a new employee) is an officer, 5% shareholder, or an employee who received compensation greater than \$120,000 (2017) and is among the top 20% of the employees ranked by compensation
- Also includes an employee who is the spouse or dependent of an HCE

Note: This is a different definition of HCE than is used for purposes of § 105(h).

Nondiscrimination Rules for Cafeteria Plans

There are three cafeteria plan nondiscrimination tests

3. Contributions and Benefits Test

- A cafeteria plan must not discriminate in favor of HCEs as to contributions and benefits. This means that a plan must:
- Give each similarly situated participant a uniform opportunity to elect qualified benefits, and the actual election of qualified benefits through the plan must not be disproportionate by HCEs; and
- Give each similarly situated participant a uniform election with respect to employer contributions, and the actual election with respect to employer contributions for qualified benefits through the plan must not be disproportionate by HCEs

Nondiscrimination Rules for Cafeteria Plans

Nondiscrimination in Actual Operation

- In addition to not discriminating as to either benefit availability or utilization, a cafeteria plan cannot discriminate in favor of HCEs in actual operation
- For example, a particular nontaxable benefit offered through the plan for a period during which only HCEs would utilize the plan or benefit

Nondiscrimination Rules for Cafeteria Plans

“Safe Harbor” for Cafeteria Plans providing health benefits

- A safe harbor test is available for plans that provide health benefits (excluding health care FSA coverage)
- The safe harbor from the contribution and benefits test exists if contributions for each participant include an amount that either:
 - Equals 100% of the cost of the benefits selected by the majority of similarly situated HCEs; or
 - Is at least 75% of the cost of the highest cost benefits selected by any similarly situated participants

Note: Any contributions above the safe harbor must be proportionate to participants' compensation.

Nondiscrimination Rules for Cafeteria Plans

“Safe Harbor” for premium-only plans

- A cafeteria plan that offers the same benefits at the same cost to all HCEs and non-HCEs is deemed to meet the nondiscrimination requirements
- This safe harbor is not available for plans offering a health care FSA

Nondiscrimination Rules for Dependent Care FSAs

Dependent Care FSAs are subject to nondiscrimination requirements under Section 129

- Eligibility Test
- Contributions and Benefits Test
- More-Than-5% Owners Concentration Test
- 55% Average Benefits Test
 - Utilization test: To ensure that HCEs do not participate disproportionately
 - Average benefits provided to non-HCEs must be at least 55% of the average benefits provided to HCEs

“Simple” Cafeteria Plans under the ACA

Simple Cafeteria Plans

- The ACA provides eligible small employers with a safe harbor from the nondiscrimination requirements for cafeteria plans, group term life insurance, and health care and dependent care FSAs
- Under the safe harbor, the plan will be treated as meeting the specified nondiscrimination requirements if the cafeteria plan satisfies minimum eligibility and participation requirements and minimum contribution requirements

“Simple” Cafeteria Plans under the ACA

Simple Cafeteria Plans – Eligible Employer

- An eligible employer is an employer who employed an average of 100 or fewer employees on business days during either of the two preceding years.
- If an employer was an eligible employer for any given year, then the employer remains an eligible employer until the employer employs an average of 200 or more employees during any year preceding any such subsequent year.
- Tax-controlled group rules apply

“Simple” Cafeteria Plans under the ACA

Simple Cafeteria Plans – Eligibility Requirement

- The eligibility requirement is met only if all employees (other than excludable employees) are eligible to participate, and each employee eligible to participate can elect any benefit available under the plan
- Excludable employees for purposes of a simple cafeteria plan are those who:
 - Have not attained age 21 before the end of the plan year;
 - Have fewer than 1,000 hours of service in the preceding year;
 - Have not completed one year of service as of any day during the plan year; or
 - Are covered under a collective bargaining agreement (CBA) or are nonresident aliens

“Simple” Cafeteria Plans under the ACA

Simple Cafeteria Plans – Minimum Contribution

- The minimum contribution requirement is met if the employer provides a minimum contribution for each non-HCE in addition to any salary reduction contributions made by the employee
- The minimum must be able to be applied toward the cost of any qualified benefit (other than a taxable benefit) offered under the plan
- The contribution must be equal to:
 - A uniform percentage (not less than 2%) of the employee’s compensation for the plan year, or
 - An amount which is not less than the lesser of:
 - 6% of the employee’s compensation for the year, or
 - 2x the amount of employees’ salary reductions

Opt-Out Payments

- Opt-out payments should be described in the cafeteria plan document as they are a choice between cash and qualified benefits
- IRS has provided guidance on opt-out payments for purposes of ACA reporting / determining cost of coverage
 - “Unconditional” opt-out payments increase the employee’s cost of coverage, unless transition relief applies
 - Transition relief for arrangements in effect prior to December 16, 2015 (and not substantially increased thereafter)
 - “Conditional” opt-out payments do not increase the cost of coverage
 - Under a conditional opt-out, payment is available only if the employee can demonstrate enrollment in other coverage

Correcting Mistakes

Little direct guidance in the Code or Regulations

- Regulations do not contain a formal correction process; however, IRS has informally indicated that an election may be changed where there is “clear and convincing evidence” that a mistake has been made
- IRS is concerned that claims of mistake could be a pretext for evading the irrevocability rule
 - In general, the standard is easier to satisfy for an employer’s mistake than for an employee’s claimed mistake
 - Errors may be corrected, even retroactively, in order to put the parties back in the position that they would have been in had the error not occurred

Correcting Mistakes – Improper Health FSA Payments

Correction Procedures for Improper Health FSA Payments

- IRS guidance for debit card payments may be applied to improper / unsubstantiated payments under a health FSA
- These procedures include:
 - Deactivating the debit card until improper payments have been recovered
 - Offsetting outstanding amounts against subsequent, substantiated claims
 - Demanding repayment from employee and withholding improper amounts from pay (to extend allowed under state law)
 - Including unrecovered overpayments in income on W-2, after the other procedures are followed

Questions?



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