

# COMPLIANCE OVERVIEW

Provided by The Stratford Group

## Section 125 Cafeteria Plans Guide

A Section 125 plan, or a cafeteria plan, allows employees to pay for certain benefits on a pre-tax basis. Specifically, employers use these plans to provide their employees with a choice between cash and certain qualified benefits without adverse tax consequences. Paying for benefits on a pre-tax basis reduces the employees' taxable income and therefore reduces both the employees' and the employer's tax liability.

In order to receive these tax advantages, a cafeteria plan must comply with the rules of Internal Revenue Code (Code) Section 125 and related Internal Revenue Service (IRS) regulations. Under these rules, a Section 125 plan must have a written plan document and can only offer certain qualified benefits on a tax-favored basis. While self-employed individuals may maintain a Section 125 plan for their employees, only common law employees may participate in the plan.

In addition, once an employee makes a Section 125 plan election, he or she may not change that election until the next plan year, unless the employee experiences a permitted election change event. Also, in order for highly compensated employees to receive the tax advantages associated with a Section 125 plan, the plan must generally pass certain nondiscrimination tests.

### LINKS AND RESOURCES

- [Internal Revenue Code Section 125](#)
- IRS' [proposed Section 125 regulations](#) from 2007 – *Taxpayers may rely on these regulations until final regulations are issued.*

### HIGHLIGHTS

#### KEY LEGAL REQUIREMENTS

To receive a federal tax advantage, Section 125 plans must comply with the following legal rules:

- Must have a written plan document;
- Only common law employees may participate on pre-tax basis;
- Elections are generally irrevocable for entire plan year; and
- Must pass certain nondiscrimination tests.

#### EXAMPLES OF QUALIFIED BENEFITS

- Group health plan coverage
- Dental and vision benefits
- Health FSA
- DCAP
- Life insurance
- Disability benefits
- Adoption assistance

This Compliance Overview is not intended to be exhaustive nor should any discussion or opinions be construed as legal advice. Readers should contact legal counsel for legal advice.

## CAFETERIA PLAN BASICS

Code Section 125 allows employers to establish a type of tax savings arrangement, called a Section 125 plan or cafeteria plan, for their employees. A Section 125 plan provides employees with an opportunity to pay for certain benefits on a pre-tax basis, allowing them to increase their take-home pay. Employers may also make nontaxable contributions to a Section 125 plan for their employees.

Under a Section 125 plan, employees choose between at least one taxable benefit (such as taxable compensation) and one or more qualified benefits. Qualified benefits include, for example, the following commonly offered employee benefits:

- ✓ Group health plans;
- ✓ Health flexible spending accounts (FSAs);
- ✓ Vision and dental plans;
- ✓ Dependent care assistance programs (DCAPs); and
- ✓ Disability and life insurance;
- ✓ Health savings account (HSAs).

According to the IRS, a Section 125 plan is the **only means** by which an employer can offer employees a choice between taxable and nontaxable benefits without causing adverse tax consequences to the employees. To avoid taxation, the Section 125 plan must meet the specific requirements of Code Section 125 and underlying IRS regulations.

**Tax Rules:** Employees who elect to participate in a Section 125 plan agree to contribute a portion of their salaries on a pre-tax basis to pay for the qualified benefits. These contributions, which are called “salary reduction contributions” are not considered wages for federal income tax purposes, and are generally not subject to Social Security and Medicare tax (FICA) or federal unemployment tax (FUTA). This reduces employees’ taxable income, which results in a savings for both employees and employers.

### Steps to implement a Section 125 plan:

- Adopt a **written plan document** that reflects the plan’s design and complies with Section 125;
- Update **plan enrollment forms** to include the rules for Section 125 plan elections; and
- Select a vendor to perform **nondiscrimination testing**.

## TYPES OF SECTION 125 PLANS

There are different types of Section 125 plans that employers can choose from when setting up their cafeteria plans. The four basic forms of Section 125 plans are as follows:

| Type of Plan                                | Description  |
|---|--|
| <b>Premium payment plans</b>                | <p>A premium payment plan is the most basic—and most popular—type of Section 125 plan. It is also called a “premium only plan” or “premium conversion plan.” A key feature of this type of plan is that it allows employees to pay their portion of premiums for qualified benefits with pre-tax dollars. Premium payment plans may also offer a cash-out option (additional taxable wages) for employees who decline insurance coverage.</p>  |
| <b>Flexible spending arrangements</b>       | <p>A Section 125 plan may allow employees to purchase benefits under a flexible spending arrangement (a health FSA, DCAP or both) on a pre-tax basis. A health FSA reimburses eligible out-of-pocket medical care expenses. A DCAP reimburses expenses that are for the care of one or more qualifying individuals and that enable the employee (and the employee’s spouse) to be gainfully employed. Additional legal requirements apply to health FSAs and DCAPs. This type of Section 125 plan may also incorporate a premium payment component, or the flexible spending arrangement may be the only benefit offered under the plan.</p>   |
| <b>Full cafeteria plan (full flex plan)</b> | <p>Under a full cafeteria plan, the employer makes contributions for eligible employees. Employees may spend the employer contribution, which are sometimes called “flex credits,” to purchase any of the benefits offered within the cafeteria plan, such as premium payments for qualified benefits, a health FSA or a DCAP. If the plan includes a cash-out option and the employer’s contribution exceeds the cost of the benefits selected by an employee, then the employee may take the excess amount as additional taxable wages. In addition, the employee may contribute pre-tax dollars to purchase additional benefits beyond what he or she can purchase with the employer's contributions.</p> |
| <b>Simple cafeteria plan</b>                | <p>Eligible small employers (100 or fewer employees) may establish “simple cafeteria plans” in order to avoid the nondiscrimination rules for Section 125 plans and certain component benefits offered under the plan. A plan qualifies as a simple cafeteria if it meets certain contribution, eligibility and participation requirements.</p>  |

## SECTION 125 - LEGAL REQUIREMENTS

In order to qualify for tax advantages, a Section 125 plan must satisfy the requirements of Code Section 125 and underlying IRS regulations, as summarized below.

### **Written Plan Document**

A Section 125 plan must be maintained pursuant to a **written plan document** that is adopted by the employer **on or before the first day of the plan year**. The plan document for a Section 125 plan must address certain topics, including the following:

- ✓ A description of the benefits available through the plan, including the periods of coverage;
- ✓ The plan's rules for employee eligibility;
- ✓ The procedures governing employees' elections under the plan, including when elections may be made, when they are effective, and any exceptions to the irrevocability rule;
- ✓ The manner for making contributions (for example, pre-tax employee contributions, employer contributions or both) and the maximum amount of contributions; and
- ✓ If the plan includes a flexible spending arrangement, a description of the special rules that apply to these accounts (for example, the uniform coverage and use-or-lose rules for health FSAs).

**Compliance Tip:** Many of the benefits that may be provided through a Section 125 plan are subject to the Employee Retirement Income Security Act (ERISA). ERISA includes its own set of requirements for written plan documents and SPDs, which are different from the Section 125 plan document requirements. Employers should confirm that their employee benefit documents comply with both sets of requirements, as applicable.

The plan document for a Section 125 plan may be comprised of more than one document. For example, the Section 125 plan document may incorporate by reference benefits that are offered through separate written plans, such as a health FSA, without describing these benefits in full. Also, other Code sections require plan documents for certain qualified benefits, including a health FSA, DCAP and adoption assistance. These requirements can be satisfied by including these benefits in the Section 125 plan document.

**Impact of Noncompliance:** According to the IRS' 2007 proposed regulations, if there is no written plan document in place or if the written plan document does not comply with the content or timing requirements, employees' elections between taxable and nontaxable benefits will result in taxable income to the employees.

A Section 125 plan may be amended, or changed, at any time during a plan year. However, amendments must be made in writing and can only be effective for periods after the later of the adoption date or the effective date of the new amendment, unless otherwise permitted by the IRS.

## ***Eligibility Requirements***

Any employer may sponsor a Section 125 plan for its eligible employees. This includes private sector businesses, including corporations, partnerships, limited liability companies and nonprofit organizations, as well as public sector employers.

Also, as a general rule, an employer may allow **any common law employee** to participate in its Section 125 plan. In addition, former common law employees (for example, COBRA participants receiving severance pay) and leased employees, as defined under Code Section 414(n), may participate in an employer's Section 125 plan.

While only employees are allowed to make elections under a Section 125 plan, a Section 125 plan may provide non-taxable benefits for an employee's spouse, dependent child who is under age 27 or tax dependent. A "spouse" means an employee's spouse as defined under federal tax law, including same-sex and opposite-sex spouses. This definition, however, does not include domestic partners. Thus, a Section 125 plan cannot provide non-taxable benefits for an employee's domestic partner who is not a tax dependent.

***Relationship to Health Plan Eligibility:*** An employer's group health plan may be designed to cover individuals who do not qualify for tax-free health coverage (for example, children who are older than age 27, grandchildren or domestic partners). Under the Section 125 rules, an employee may only pay pre-tax for coverage of a spouse, a child under age 27 or a tax dependent. As a general rule, coverage for other individuals should be paid for on a post-tax basis.

Additionally, although individuals who are not considered employees, such as self-employed individuals, partners in a partnership and more than 2 percent shareholders in a Subchapter S corporation, can sponsor a Section 125 plan for their employees, these self-employed individuals cannot participate in a Section 125 plan on a tax-favored basis. Likewise, directors of a corporation who are not also employees cannot participate in a Section 125 plan on a tax-favored basis.

## ***Qualified Benefits***

A Section 125 plan must offer employees a choice between at least one taxable benefit (such as taxable compensation) and one or more qualified benefits. Benefits that are not qualified benefits cannot be offered under a Section 125 plan. The following table lists commonly offered employee benefits and indicates whether they are qualified benefits that can be offered under a Section 125 plan.

| Type of Benefit                                    | Can the Benefit be Offered under a Section 125 Plan?   |
|--|--|
| Accidental death and dismemberment (AD&D) coverage | Yes  |
| Adoption assistance program                        | Yes<br><i>Although adoption assistance benefits provided through a Section 125 plan are not subject to federal income tax, they are subject to federal employment taxes, such as FICA and FUTA. Also, the additional Section 125 rules for flexible spending arrangements generally apply to adoption assistance benefits.</i> |
| COBRA coverage                                     | Yes, if the employee has compensation that can be used to pay for coverage on a pre-tax basis  |
| Dental benefits                                    | Yes  |
| DCAP   | Yes  |
| Disability coverage (short-term or long-term)      | Yes<br><i>The tax rules for payment of disability benefits depend on how premiums for the coverage are paid. If premiums are paid on a pre-tax basis, disability benefits are taxed when an employee becomes disabled.</i>   |
| Educational assistance plans                       | No<br><i>Employers may offer tax-free educational assistance benefits (up to \$5,250) to employees through a qualified educational assistance program under Code Section 127.</i>  |
| Transportation fringe benefits                     | No<br><i>Employers may offer tax-free transportation benefits, such as parking and transit passes, to employees through a qualified transportation plan, up to certain annual limits.</i>  |
| Other fringe benefits under Code Section 132       | No   |
| Group health plan coverage                         | Yes  |

|   |   |
|---|---|
| Health FSA  | Yes   |
| Health reimbursement arrangement (HRA)                        | No  |
| HSA   | Yes   |
| Individual insurance policies (major medical coverage)        | No  |
| Life insurance (on employee's life)                           | Yes, but the cost of insurance coverage in excess of \$50,000 is taxable. |
| Life insurance (on life of an employee's spouse or dependent) | No  |
| Long-term care insurance                                      | No  |
| Vision benefits   | Yes   |

## Employee Elections

### Prospective Only

Participant elections under a Section 125 cafeteria plan must be made **before the first day of the plan year or the date taxable benefits would currently be available, whichever comes first**. Typically, employees make their elections each year during an annual open enrollment period, with the elections taking effect on the first day of upcoming plan year. Employees who become eligible for benefits during a plan year (for example, new hires), will usually make their elections during an initial enrollment period.

There are **two exceptions** to the general rule that Section 125 plan elections must be made on a prospective (not retroactive) basis:

- ✓ **Limited exception for new hires** – Elections that new employees make within 30 days after their hire date can be effective on a retroactive basis. Elections made during this enrollment window can be effective as of the employee's date of hire.
- ✓ **HIPAA special enrollment** – Special enrollment rights apply when an employee acquires a new dependent through marriage, birth, adoption or placement for adoption. When a new dependent is acquired through birth, adoption or placement for adoption, coverage must be effective retroactively to the date of birth, adoption or placement for adoption. Employees' elections under a Section 125 plan may be retroactive to correspond with this HIPAA special enrollment right.

## *Irrevocable for Entire Plan Year*

Participant elections generally must be **irrevocable until the beginning of the next plan year**. This means that participants ordinarily cannot make changes to their cafeteria plan elections during a plan year. Employers do not have to permit any exceptions to the election irrevocability rule for cafeteria plans. However, IRS regulations permit employers to design their cafeteria plans to allow employees to change their elections during the plan year, if certain conditions are met.

Cafeteria plans may recognize certain events as entitling a plan participant to change his or her elections (if the change is consistent with the event). Although a cafeteria plan may not be more generous than the IRS permits, it may choose to limit to a greater extent the election change events that it will recognize.

For an employee to be eligible to change his or her cafeteria plan election during a plan year, the following general rules apply:

1. The employee must experience a midyear election change event recognized by the IRS.

2. The cafeteria plan must permit midyear election changes for that event.

3. The employee's requested change must be consistent with the midyear election change event.

Also, employees' midyear election changes must be effective prospectively. The one exception to this rule is for retroactive election changes that are permissible under the HIPAA special enrollment event for birth, adoption or placement for adoption.

Some of the IRS' midyear election change events apply to all qualified benefits that can be offered under a cafeteria plan. However, other midyear election change events only apply to certain qualified benefits— for example, not all of the IRS' midyear election change events apply to elections for health FSAs.

**The irrevocable election rules do not apply to a cafeteria plan's HSA benefit.** An employee who elects to make HSA contributions under a cafeteria plan may start or stop the election or increase or decrease the election at any time during the plan year, as long as the change is effective prospectively. If an employer places additional restrictions on HSA contribution elections under its cafeteria plan, then the same restrictions must apply to all employees. Also, to be consistent with the HSA monthly eligibility rules, HSA election changes must be allowed at least monthly and upon loss of HSA eligibility.

## *Permitted Election Change Events*

Cafeteria plans may recognize certain events where an employee is entitled to make election changes during a plan year. The IRS recognizes three broad categories of midyear election change events:

- ✓ Change in status events (major life events, such as marriage, birth, adoption and certain employment changes);



- ✓ Changes in cost or coverage for the plan’s qualified benefits; and
- ✓ Other laws or court orders (for example, COBRA, HIPAA and the Affordable Care Act).

Although a Section 125 plan may not be more generous than the IRS permits, it may choose to **limit to a greater extent** the election change events that it will recognize. An employer that recognizes one or more midyear election change events allowed by the IRS should review its plan document to confirm that it addresses the permitted election changes. Also, employers with fully insured plans should confirm that any permitted election change events are consistent with the rules of the underlying insurance policy.

| Midyear Election Change Events  |  |   |
|---|--|---|
| <ul style="list-style-type: none"> <li>• Change in employee’s marital status</li> <li>• Change in employee’s number of dependents</li> <li>• Change in employment status of employee or employee’s spouse or dependent</li> <li>• A dependent satisfies or ceases to satisfy plan’s eligibility rules</li> <li>• Change in place of residence of employee, spouse or dependent</li> </ul> | <ul style="list-style-type: none"> <li>• Cost changes for the benefit package option</li> <li>• Significant curtailment of coverage (this can be a complete loss of coverage or a significant change, such as a significant increase in the deductible, copayment or out-of-pocket maximum)</li> <li>• Addition or significant improvement of benefits package option</li> <li>• Change in coverage under other employer plan</li> <li>• Loss of health coverage sponsored by governmental or educational institution</li> </ul> | <ul style="list-style-type: none"> <li>• HIPAA special enrollment rights</li> <li>• COBRA qualifying event (or similar state law continuation coverage event)</li> <li>• Judgments, decrees or orders (including QMCSOs)</li> <li>• Entitlement to Medicare or Medicaid</li> <li>• Family Medical Leave Act (FMLA) leave</li> <li>• Exchange enrollment</li> <li>• Reduction in hours of service</li> </ul> |

Note that different midyear election change rules apply to some qualified benefits, such as health FSAs and DCAPs.

### ***Nondiscrimination Tests***

Section 125 plans must generally pass certain tests that are designed to ensure that the plan does not discriminate in favor of highly compensated employees. If a cafeteria plan fails to pass nondiscrimination testing, highly compensated employees lose the tax benefits of participating in the plan (that is, they must include the benefits or compensation in their income). However, even if a cafeteria plan is discriminatory, non-highly compensated employees will not lose the tax benefits of participating in the plan.

In general, a cafeteria plan must satisfy the following three nondiscrimination tests:

|          |  |  |
|----------|--|--|
| <b>1</b> | <b>Eligibility Test</b>                | This test looks at whether a sufficient number of non-highly compensated employees are eligible to participate in the cafeteria plan. If too many non-highly compensated employees are ineligible to participate, the plan will fail this discrimination test. |
| <b>2</b> | <b>Benefits and Contributions Test</b> | This test is designed to make sure that a plan's contributions and benefits are available on a nondiscriminatory basis and that highly compensated employees do not select more nontaxable benefits than non-highly compensated employees select.              |
| <b>3</b> | <b>Key Employee Concentration Test</b> | This test looks at whether key employees impermissibly utilize the plan's benefits more than non-key employees. Under this text, key employees must not receive more than 25 percent of the aggregate nontaxable benefits provided to all employees.           |

Certain exceptions and safe harbors apply to the cafeteria plan nondiscrimination tests. For example, a Section 125 plan that is a premium only plan is deemed to satisfy the cafeteria plan nondiscrimination requirements if it passes the eligibility test. In other words, the plan will automatically satisfy the contributions and benefits test and the key employee concentration test if it passes the eligibility test. In addition, simple cafeteria plans are treated as meeting the Section 125 nondiscrimination requirements as long as certain eligibility, participation and minimum contribution requirements are met.

## REPORTING AND DISCLOSURE

Because a Section 125 plan is tax savings arrangement, it generally is not subject to the reporting and disclosure requirements that apply to employee benefit plans under federal law. This means, for example, that a Section 125 plan is not required to file an annual Form 5500 with the Department of Labor (DOL) and is not required to have a summary plan description (SPD). However, many of the benefits that can be purchased on a tax-free basis through a Section 125 plan (for example, a health FSA) are subject to the federal reporting and disclosure requirements for employee benefit plans, unless an exception applies.

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