

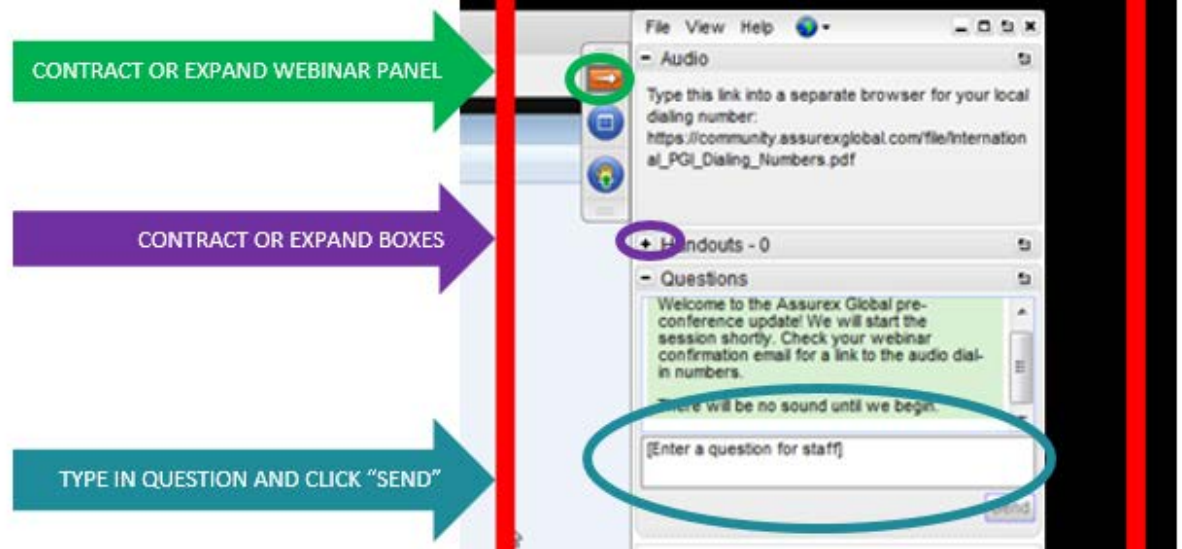
June 22, 2017

# Section 125 Cafeteria Plan Rules Review

Presented by Benefit Comply

## Section 125 Cafeteria Plan Rules Review

- Welcome! We will begin at 3 p.m. Eastern
- There will be no sound until we begin the webinar. When we begin, you can listen to the audio portion through your computer speakers or by calling into the phone conference number provided in your confirmation email.
- You will be able to submit questions during the webinar by using the “Questions” box located on your webinar control panel.
- Slides can be printed from the webinar control panel – expand the “Handouts” section and click the file to download.



## Section 125 Cafeteria Plan Rules Review

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# Assurex Global Partners

- Catto & Catto
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- RHSB
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- Seacrest Partners
- Starkweather & Shepley Insurance Brokerage
- Woodruff-Sawyer & Co.
- Wortham Insurance & Risk Management

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# Background and History

- §125 was enacted in 1978 as part of the Revenue Act of 1978
- August 2007 Proposed Cafeteria Plan Regulations
  - Rescinded both temporary and never finalized proposed regulations issued in 1984, 1986, 1989, 1997 and 2000 as well as additional sub-regulatory guidance
  - Essentially consolidated and restated prior guidance
  - Also addressed key changes in the law during intervening years
  - In that prior guidance was rescinded, 2007 proposed regulations “may be relied upon until finalized,” but... it hasn’t happened yet!

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# Cafeteria Plan Basic Concepts

- **Constructive Receipt (IRC §1.451-2(a))**
  - Income is constructively received in the taxable year during which it is received or otherwise made available...
  - §125 allows employer to ignore constructive receipt and allow employees to use what would normally be treated as taxable compensation to purchase certain benefits on a pre-tax basis
- **Certain Conditions must be Satisfied**
  - Plan must provide a choice between at least one taxable and one non-taxable benefit
    - Could be as simple as choosing to enroll and pay for health insurance (non-taxable), or not enroll and keep your compensation (taxable)
  - Cannot defer either income or benefits from one tax year to another (some exceptions discussed later)
  - Elections once made are irrevocable (subject to exceptions articulated in the rules)
  - All pre-tax elections must be made prospectively (again subject to a couple of exceptions)

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# Legal Requirements

- Plan Documentation
  - Plan must be in writing
  - §125 cafeteria plan document is typically a separate document from plan documents and SPD required by ERISA
  - Document and/or amendments must be completed prior to effective date
  - If no document... there is no plan!
- Who Can Sponsor a Cafeteria Plan?
  - Any employer regardless of size
  - Controlled groups and affiliated service groups
    - May provide a single plan for all members
    - Each entity may have separate plan for its employees

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# Legal Requirements (continued)

- Who Can Participate in a Cafeteria Plan
  - Individuals eligible to participate
    - Current employees
    - Former employees
  - Individuals ineligible to participate
    - Self-employed individuals (sole proprietors, individual owner LLCs)
    - Partners of an organization structured as a partnership (includes partnership and multi-owner LLCs)
    - > 2% owners of Subchapter S corporations
    - Spouses and dependents
      - Cannot directly participate, but employee can use plan to provide spouse and dependent benefits
      - Spouses and dependents may be able to participate directly in a health FSA as a COBRA qualified beneficiary (more later)

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# Legal Requirements (continued)

- No Deferred Compensation
  - No benefits may be offered that defer compensation from one tax year to another (example whole life insurance, long term care insurance, etc.)
  - Exceptions to the No Deferral of Benefits Rule
    - Optional 2 1/2/ month grace period
      - Plan may allow HFSA balance available at end of plan year to be used to reimburse eligible expenses incurred during grace period
    - Optional carry over of up to \$500 (more later)
    - Salary reductions taken in last month of plan year used to pay for coverage provided in first month of following plan year



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## Election Changes

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# Election Changes

- Basic Requirements (IRC §1.125-4))
  - Pre-tax elections are irrevocable and cannot be changed unless for a reason permitted under the Code
  - Revised election must be “consistent” with the nature of the status change
- The Code indicates what is permitted... not what is required
  - Definition of allowable status changes becomes a plan design consideration
  - The cafeteria plan document is always the ultimate source to determine whether a particular status change is recognized by the plan
  - In practice most plans are written to allow the majority (if not all) permitted election changes

## Table of Events Permitting Election Changes

### Change in Status

- change in employee's legal marital status (gain or lose a spouse);
- change in number of dependents;
- change in employment status for employee, spouse or dependent that affects eligibility;
- dependent satisfies (or ceases to satisfy) eligibility requirements;
- change in residence; and
- commencement or termination of adoption proceedings

### Change in Cost of Benefits

### Significant Curtailment or Improvement of Coverage

### Change in Coverage Under Other Employer Plan (inc. when two employer plans have different plan years)

### Loss of Group Health Coverage Sponsored by Governmental or Educational Institution

### HIPAA Special Enrollments

### COBRA Qualifying Events

### Judgments, Decrees, or Orders

### Medicare or Medicaid Entitlement

### FMLA

### HSA

### Individual plan enrollment

- Participants permitted to revoke elections for employer-sponsored plan due to reduction in hours even if there is no loss in eligibility (e.g. during the stability period) if enrolling in other coverage
- Participants permitted to revoke elections for employer-sponsored group health plan if the participant chooses to enroll through the public Marketplace during open enrollment or a special enrollment period

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# Election Changes

- Change in Status
  - Includes Six Categories of Events
    - Change in employee's marital status
    - Change in the number of dependents
    - Change in employment status
    - Dependent satisfies or ceases to satisfy definition of dependent
    - Change in residence
    - Commencement or termination of adoption proceedings

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# Election Changes

- Plan Cost or Coverage Changes
  - “Insignificant” cost changes
    - Employer can make automatic adjustment of participant pre-tax contributions
  - Significant cost changes
    - Employer could allow the employee to make coverage changes (but is not required to allow changes)
  - Significant curtailment of benefit or loss of benefit option
  - Significant expansion of benefit or addition of benefit option
  - Change in coverage under another employer’s plan
    - (e.g. change in coverage to spouse’s plan)

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# Election Changes

- ACA Related Mid-Year Election Change Opportunity
  - Special transition rule allows one mid-year election change (without the occurrence of an otherwise permitted status change) in order to:
    - Discontinue coverage through an employer-sponsored plan in order to secure coverage through an Exchange; or
    - For individuals not covered under their employer-sponsored plan, to enroll in the plan to avoid the individual responsibility payment
  - Employers are not required to allow for these election changes, but to do so the cafeteria plan may be amended retroactively to implement these rules
- Other Events Which Permit Election Changes
  - Judgments, decrees or orders
  - Medicare or Medicaid entitlement
  - Loss of group health coverage sponsored by a governmental or educational institution
  - FMLA leave of absence
  - COBRA qualifying events

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# Special Election Change Situations

- HIPAA Special Enrollments

- Loss of eligibility for coverage under a group health plan or health insurance
- Acquisition of new spouse or dependent by marriage, birth, adoption, or placement for adoption
- Loss of eligibility for Medicaid or state children's health insurance program (CHIP) coverage
- Gaining eligibility for a state premium assistance subsidy under the plan from Medicaid or CHIP

- HSAs

- If HSA are offered through a cafeteria plan, employee must be allowed to make pre-tax payroll contributions to their HSA account
- Employer must allow employee to change HSA contributions on at least a monthly basis

# Election Changes

- Health FSA election changes
  - Not all events allow the participant to make changes to the amount of health FSA elections

Health FSA Changes Allowed	Health FSA Changes Not Allowed
Change in status: <ul style="list-style-type: none"><li>• Change in number of dependents</li><li>• Change in employment status</li><li>• Change in dependent eligibility status</li></ul>	Change in residence
Judgments, decrees or orders	Cost changes
Medicare or Medicaid entitlement	Significant curtailment or improvement of coverage
FMLA	Change in coverage under another employer's plan
	HIPAA special enrollment rights
	HSA election changes
	ACA-related changes



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# Common Election Change Questions

- Issues That Must be Considered
  - Employee wants to terminate someone from the plan & reduce pre-tax election
    1. Is the election change permissible under the Section 125 rules?
    2. Is the change requested consistent with the event?
    3. Does that particular Section 125 plan include the event in the plan document?
    4. What do the health plan's particular eligibility rules state?
  - Employee wants to add someone to the plan & increase pre-tax election
    1. Is the plan required to allow the mid-plan year election because the event is a HIPPA special enrollment?
    2. Will the carrier (or stop-loss carrier) allow a mid-plan year enrollment if it is not required by HIPAA special enrollment rules?
    3. If enrollment is allowed, all of the same questions as above must be addressed

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# Common Election Change Questions

- Can My Employee Add a Spouse Mid-Plan Year Because the Spouse's Employer is Charging More for Coverage?
  1. Is the plan required to allow the mid-plan year election because the event is a HIPAA special enrollment?
    - No – This is not a HIPAA special enrollment since the spouse has not lost eligibility in their plan, so the plan is not required to allow this
  2. Is the election change permissible under the Section 125 rules?
    - Yes – Under Section 125 status change rules, a significant change in cost under the spouse's plan allows the employee to make an election change
- A. If employer wants to allow the change, the employee can change their pre-tax election but don't forget:
  1. What do the health plan's particular eligibility rules state?
  2. Will the carrier (or stop-loss carrier) allow a mid-plan year enrollment if it is not required by HIPAA special enrollment rules?

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# Common Election Change Questions

- My Spouse Terminated Employment But Was Not Covered By a Plan at the Time of Termination. Can I Add My Spouse to My Group Plan Mid-Plan Year?
  1. Is the plan required to allow the mid-plan year election because the event is a HIPAA special enrollment?
    - No – Termination of employment without a loss of coverage does not trigger a HIPAA special enrollment requirement.
  2. Is the election change permissible under the Section 125 rules?
    - Yes – Under Section 125 status change rules, the spouse's change in employment status allows the employee to make an election change
- A. If employer wants to allow the change, the employee can change their pre-tax election but don't forget:
  1. What do the health plan's particular eligibility rules state?
  2. Will the carrier (or stop-loss carrier) allow a mid-plan year enrollment if it is not required by HIPAA special enrollment rules?

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# Common Election Change Questions

- I Was Covered Under My Spouse's Plan and My Coverage Was Terminated Because We Failed to Make a Required Premium Payment. Can I Join My Employer's Plan Mid-Plan Year?
  1. Is the plan required to allow the mid-plan year election because the event is a HIPAA special enrollment?
    - No – Loss of coverage due to failure to pay premium does not trigger a HIPAA special enrollment requirement.
  2. Is the election change permissible under the Section 125 rules?
    - No – loss of coverage due to failure to pay premium is not a Section 125 election change event
- A. If employer wants to allow the change, the employee would need to pay for spouse's coverage on an after-tax basis until the next annual election period. But don't forget:
  1. What do the health plan's particular eligibility rules state?
  2. Will the carrier (or stop-loss carrier) allow a mid-plan year enrollment if it is not required by HIPAA special enrollment rules?

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# Common Election Change Questions

- I Am Covered By My Employer's PPO Plan and I Get Married - When I Add My New Spouse to My Coverage Can I Change to My Employer's HDHP Plan Alternative?
  1. Is the plan required to allow the mid-plan year election because the event is a HIPAA special enrollment?
    - Yes - new spouse through marriage triggers a HIPAA special enrollment requirement
  2. Is the election change permissible under the Section 125 rules?
    - Yes - All HIPAA special enrollments are also a Section 125 election change event
  3. Can the employee switch benefit options?
    - Yes - Employees must be allowed to make benefit option changes in conjunction with a HIPAA special enrollment

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## Health FSA Overview

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# Health FSAs

- Basic Design and Administrative Issues
  - Uniform coverage rule
    - Full election amount must be made available to participant at any time during the plan year no matter how much the participant has contributed
  - “Use It or Lose It” rule
    - Optional \$500 roll-over is exception to this rule
  - Optional Grace Period
    - Employer must choose between grace period and roll-over, plan cannot provide for both
- Expenses Eligible for Reimbursement...
  - Must be for medical care based on IRS Code section 213(d) expense rules
    - IRS Publication 502 is a helpful document
  - Must be incurred by employee, spouse or other eligible individual
  - Must be incurred during the coverage period
  - Cannot be eligible for reimbursement from any other source
  - Must be adequately substantiated

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# Health FSAs (continued)

- Basic Design and Administrative Issues (continued)
  - COBRA... perhaps! (more later)
  - HIPAA privacy and security
    - A common mistake made by fully-insured employers is that they think they have limited HIPAA privacy and security obligations
    - Health FSA is considered a self-funded medical plan subject to all HIPAA privacy and security requirements
    - Only exception is if HFSA has less than 50 participants AND the employer self-administers the plan



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# Health FSA and ACA

- Maximum HFSA Salary Reduction Limitation
  - Limited to \$2,500 (indexed) per employee year
  - If employee participates in multiple HFSA's maintained by members of a controlled group or affiliated service group, a single \$2,500 limit applies
  - If employee participates in multiple HFSA's maintained by separate employers, the \$2,500 limit applies to each employer
  - Spouses are each eligible for the \$2,500 maximum even if they are participants in the same plan
  - Optional grace period or \$500 roll-over provisions do not effect the contribution limit

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# Health FSA Excepted Benefit Status

- HFSA Must Qualify as an Excepted Benefit to Meet ACA Requirements
  - Condition 1: Other non-excepted group health plan coverage
    - Other group health plan coverage must be available for the year to the class of participants eligible for the HFSA
  - Condition 2 – Maximum Benefit
    - Maximum benefit payable under the HFSA cannot exceed the greater of:
      - Two times the participant's annual salary reduction election under the HFSA
      - The amount of the participant's salary reduction election for the HFSA for the year plus \$500
    - Examples
      - Employer contributing \$500 or less
      - Employer contributing a match of the employee contribution

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## Section 125 Discrimination Testing

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# Cafeteria Plan Testing Highlights

- **Several Tests Apply to Cafeteria Plans (Code Section 125)**
  - Key Employee Concentration Test: No more than 25% of all non-taxable benefits under the cafeteria plan may be for the group composed of officers with annual compensation greater than a specified dollar threshold (indexed, \$170,000 for 2014), more-than-5% owners, and more-than-1% owners with compensation over \$150,000 (not indexed)
  - Eligibility Test: A ratio-percentage test similar to that under section 105(h), but with key differences (for example, HCIs include officers, more than 5% shareholders, employees with compensation over \$115,000 (indexed), as well as spouses and dependents of the foregoing)
  - Contributions and Benefits Test: A utilization standard is imposed, making it more difficult to pass if HCI usage is higher than non-HCI usage
- **Premium Only Safe Harbor**
  - If a cafeteria plan's only feature is pre-tax premium payments, and it passes the safe harbor ratio percentage eligibility test, the key employee concentration test and contributions and benefits test are deemed satisfied

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# Cafeteria Plan Testing

- Dependent Care Plan Tests
  - Average Benefit Test
    - Average DCAP benefit for non-HCIs must be at least 55% of the average benefit for HCIs (using cafeteria eligibility definition of HCI)
    - This is the most common test for employers to fail
    - Should you test on all eligible vs test on participants only?
  - More than 5% Owners Concentration Test
  - Contributions and Benefits Test
  - Eligibility Test

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# Cafeteria Plan Testing Alert

- When to Test
  - Regulations state tests should be run as of last day of plan year
  - Employers often test after enrollment to see if there are any problems
    - Gives employer time to make corrections prior to the end of the plan year
  - If there are significant changes to enrollment or benefits, it is a good idea to test during the year
    - Gives employer time to make corrections prior to the end of the plan year
- Common Testing Problems and Issues
  - Failure to test on required controlled group basis
  - Conducting some, but not all, required tests

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## Important Cafeteria Plan Administration Issues and Challenges

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# FMLA and Section 125

- Election Changes During FMLA Leave
  - An employer must allow employee going on unpaid FMLA leave one of two options:
    - Revoke or continue health coverage (including health FSA coverage)
    - Require that health coverage continue, but allow the employee to discontinue contributions
      - In this case, the employer would pay the premiums during the leave and recover them when the employee returns
  - Return from FMLA leave is an event which allows employer to permit an employee election change
    - In addition, regulations allow an employer to require employee to reinstate benefits upon return from FMLA leave



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# FMLA and Section 125

- Premium Payment Under a Section 125 Plan During Unpaid FMLA Leave
  - Prepay on a pre-tax basis
    - Employer cannot require prepayment
    - Prepayment can not be pre-tax if leave straddles two plan years
    - Example:
      - Calendar plan year
      - Leave from November through January
      - Can only prepay November and December pre-tax
  - Pay-as-you-go
    - Paid with after-tax dollars during unpaid leave
  - Catch-up on a pre-tax basis
    - Employer and employee agree in advance that pre-tax “catch-up” contributions will be taken out of pay upon return from leave

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# FMLA and Section 125

- Section 125 Health FSA (HFSA) and FMLA
  - Employee must be allowed to revoke HFSA election when going on FMLA leave
    - Employer may require HFSA must be reinstated upon return
    - If HFSA is revoked - claims incurred during leave may not be reimbursed
  - Assuming HFSA is revoked - premium payments and coverage upon reinstatement
    - Prorated for the year based on period of coverage paid for by employee
    - or
    - Employee makes up missed contributions and full coverage election amount is provided
      - Claims may still not be reimbursed for the time employee was on FMLA and not covered by HFSA

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# FMLA and Section 125

- Example

- \$1200 HFSA election for year (\$100/mo.)
- Employee revokes HFSA election during 3-month unpaid FMLA leave
- Upon return, employee has two options:
  1. Reinstate and continue to pay \$100/mo.
    - Maximum plan year benefit available now = \$900 (\$1200 original election minus \$300 for period no contributions were made to plan)
  2. Reinstate with additional \$300 payroll deduction for balance of plan year to make up for missed contributions
    - Maximum benefit available = \$1200
    - Claims incurred during FMLA leave still may not be reimbursed, but full annual election amount is available for claims incurred while actively at work

# Section 125 and COBRA

- Employer Must Offer Health FSA Upon COBRA Event
  - COBRA premium equals 1/12 of employee annual HFSA election
  - Any COBRA qualified beneficiary (including spouse and dependents) can elect

		Benefit
1/1/17	Employee Elects HFSA deductions of \$2400	\$2400
2/1/17	Employee submits \$400 claim	\$2000
6/30/17	Spouse Divorces Employee – Benefit still available	<b>\$2000</b>
	Premium for remainder of plan year	<b>\$1200</b>
	<b>Plan Must Offer COBRA</b>	

		Benefit
1/1/17	Employee Elects HFSA deductions of \$2400	\$2400
2/1/17	Employee submits \$2000 claim	\$ 400
6/30/17	Spouse Divorces Employee – Benefit still available	<b>\$2000</b>
	Premium for remainder of plan year	<b>\$1200</b>
	<b>Plan Not Required to Offer COBRA</b>	

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# Section 125 and COBRA

- Other COBRA Issues
  - Employee can pay for COBRA coverage on a pre-tax basis
    - Employee changed from full-time to part-time
    - Terminated employee pays for some portion of COBRA coverage pre-tax out of final paycheck
  - COBRA qualified beneficiaries who elect HFSA can submit claims for full reimbursement, then stop paying for COBRA
    - Under Section 125 HFSA uniform coverage rule, employer must be at risk

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# Health FSA Transition to HSA

- HSA Background
  - Benefit comprised of two components: a HSA and a HDHP
  - In order to contribute to a HSA, the employee must be an “eligible individual,” which means...
    - Is covered under a HDHP;
    - Is not enrolled in Medicare;
    - Cannot be claimed as a dependent on another individual’s tax return; and
    - Is not covered by another health plan that is not a HDHP
      - Some exceptions allowed

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# Health FSA Transition to HSA

- HSAs and Health FSAs

- Participation in a general-purpose HFSA disqualifies an individual from contributing to an HSA
  - Applies if individual is eligible under their own HFSA or that of a spouse
  - May not contribute to HSA until the end of the HFSA plan year, regardless of whether or not HFSA funds have been exhausted
- Grace period or carryover provisions may extend ineligibility
  - Grace period
    - If there is a zero balance at the end of the plan year, individual may contribute the following year
    - If there is a year-end balance, individual is ineligible through the end of the grace period unless the grace period is made limited-purpose
  - Carryover
    - Individual is ineligible for the entire plan year (\$500 can be used any time during the year)
    - May allow participants to waive the carryover or make it limited-purpose or post-deductible

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# Health FSA Transition to HSA

- Transition Options / Recommendations
  - If there are assets remaining, there is nothing to preclude use of the HFSA's grace period while covered under the HDHP – individual just can't make HSA contributions during this time
  - Consider amending the cafeteria plan to convert to a limited scope and/or post deductible HFSA upon participation in a HDHP
  - Communicate early and communicate often!
  - Make sure cafeteria plan document reflects intent and is both amended (if necessary) and executed prior to the effective date of the change



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