VEHI Memo

Cafeteria Plans (§ Section125) – IRS Limits on Elections, Timing and Mid-Year Changes

March 2018

IMPORTANT

Please be aware the information provided is limited to health plan coverage and does not address change in status opportunities that may apply to other qualified benefits under a Cafeteria Plan/Section 125 Plan.

Further, Cafeteria Plans must be established and maintained by the employer sponsoring the plan.

Each school should have a Cafeteria Plan that addresses change in status events unless the school only offers after-tax benefits. VEHI does not retain a copy of a school's cafeteria plan. These materials have been prepared as a tool in making determinations for change in status events. It does not replace the need to maintain a Cafeteria Plan that properly reflects the school's permissible change in status events. Therefore, it is always necessary to review your cafeteria plan when making a determination regarding whether an election change is appropriate.

This memo is for <u>general guidance</u> purposes only—it is NOT legal advice.

The tax code permits employers to allow employees to contribute to certain benefit plans, known as "qualified benefits'[1] on a pre-tax basis. This means the wages used to pay for these benefits are deducted from the employee's earnings before most taxes are applied. In addition, the contributions are not included in the employee's W-2 Box 1 wages for the year. For many employees this ultimately results in a reduction in income taxes as well as payroll taxes (FICA). The employer also saves on some taxes since they do not pay the matching FICA contribution. Of course, the reduction in earnings subject to FICA also affects an individual's ultimate benefit under Social Security. That reduction can vary significantly depending on the amount the individual excludes from the program over the years they are employed.

[1] The term "qualified benefit " means benefits that are excludable from an employee's gross income even if not offered through a Cafeteria Plan — (1) health plan coverage (including dental, vision, EAPs), (2) group term life insurance coverage, (3) short and/or long term disability coverage, (4) dependent care assistance plans and (4) adoption assistance plans. Two additional benefits can be offered through a Cafeteria Plan, however the change in status rules applicable to other benefits do not apply to these plans.

- 401(k) plan cash or deferred arrangement;
- health savings accounts (HSAs).

Because this option affects tax revenue and is potentially subject to abuse, the IRS has very specific rules limiting the election of benefits under Cafeteria Plans[2] as well as when an employee can make a change to an election under the plans. These are the election and change in status rules.

Rules Applicable to All Elections
(New Hire, Open Enrollment or Mid-Year)

Plan Must Describe Election Periods

A Cafeteria Plan must contain rules and procedures about employees' elections. Elections must be irrevocable unless based on a permitted status change and must be prospective. Further, the plan must specify the timing of:

- the period during which elections may be made; and
- the period with respect to which they are effective.

Election Periods must generally be Prospective

Elections generally must be made in advance, on a prospective (not retroactive) basis. This may be done either during an annual open enrollment period or during a mid-year enrollment window for new hires or employees who qualify for exceptions to the irrevocability requirement (i.e., a mid-year election change). Election changes funded through salary reduction under a Cafeteria Plan must be prospective, with two exceptions:

- a limited 30-day retroactive enrollment window for new hires, and
- the retroactive special enrollment right under HIPAA that applies to a birth, adoption, or placement for adoption.

The Cafeteria Plan and the underlying qualified benefit plans are separate plans. While rules that apply to health plan coverage ***require*** *employers to allow certain special enrollment opportunities, Cafeteria Plans are not* ***required*** *to permit any change in elections mid-year. The Cafeteria Plan rules represent the maximum mid-year changes allowed under IRS rules. However, for practical purposes, employers include at least the required special enrollment opportunities as change-in-status events.*

Special Rule the Election Change Must Be "Consistent" With the Event

Even if an employee (or dependent) experiences a change in status recognized under the IRS rules, the rules also require the employee's election change be consistent with the event.

When a change in status event occurs, a Cafeteria Plan can only permit employees to make election changes that are consistent with the event. The rules explain (and limit) the election changes considered to meet this consistency requirement.

There are two *special rules* that apply to health plan coverage.

1. A rule that limits the election changes that can be made upon a divorce, annulment, legal separation, death of a spouse or dependent, or a dependent's ceasing to satisfy the eligibility requirements for coverage. Under this rule, the employee can cancel health coverage for only

[2] §125 plans, named for the Internal Revenue Codes section permitting the pre-tax elections.

the spouse or dependent, as applicable. An election to cancel accident or health coverage for anyone else fails to correspond with that change in status.

2. A limitation on election changes to cease or decrease coverage because of a gain in eligibility under a family member's plan (another employer's Cafeteria Plan) as a result of a change in marital or employment status. Then, an employee's election to cease or decrease coverage for the individual under the Cafeteria Plan corresponds with the change in status only if coverage for that individual actually becomes effective or is increased under the other employer's plan.

If the two special rules do not apply to a change in status event, the employer should apply the *general consistency rule*. Under the "general consistency rule," an election change satisfies the consistency requirement if (1) the change in status event affects eligibility for coverage under an employer's plan; and (2) the election change must be on account of and correspond with the event.

The first determination to be made is whether the change in status event affects eligibility under an employer's plan. Assuming that the change in status event affects eligibility under an employer's plan, the next step is to determine whether the election change is on account of and corresponds with the change in status event.

As a general rule, however, if one type of coverage is lost or gained, then the employee is limited to changing an election with respect to that coverage. Informal guidance explains only similar coverages can be changed. For example, if dental coverage is lost, then dental coverage or health FSA coverage may be added, but not major medical or vision coverage.

Change in Status Event Categories

Under the rules, events falling within the following categories are change in status events:

- change in legal marital status;
- change in number of dependents;
- change in employment status;
- dependent satisfies or ceases to satisfy dependent eligibility requirements;
- residence change; and
- for adoption assistance provided through a Cafeteria Plan, the commencement or termination of an adoption proceeding.
- Cost Changes
    - With Automatic Election Increases/Decreases
    - Significant Cost Changes
- Addition or Improvement of Benefit Package Option
- Change in Coverage of Spouse or Dependent under another Employer Plan
- Judgments, Decrees, or Orders

- Entitlement to Medicare or Medicaid
- Significant Curtailment of Coverage
- Exchange Enrollment

The following charts (Section 125 Plan Status Change Common Events and Section 125 Plan Status Change Less Common Events) provide more specific detail as to health plan coverage (including health FSAs), the recognized change in status events and the maximum changes permitted under IRS rules.

The term ‘Health Plan’ refers to medical, dental, vision and EAP coverage.

The phrase ‘Ability to Change Coverage Option’ refers to whether the employee must be offered the opportunity to change plan options (e.g., high PPO plan to low PPO plan, HMO to PPO, etc.). In some cases the option must be made available.

The phrase ‘Event Applies to the Plan’ is provided to allow you to review your plan document and determine if the specific change in status event applies under your Cafeteria Plan.