

Cafeteria Plans

Frequently Asked Questions

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We share this information with our clients and friends for general informational purposes only. It does not necessarily address all of your specific issues. It should not be construed as, nor is it intended to provide, legal advice. Questions regarding specific issues and application of these rules to your plans should be addressed by your legal counsel.

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General

1. What is a Cafeteria Plan?

A cafeteria plan is a separate written plan that meets the specific requirements and regulations of Section 125 of the Internal Revenue Code, and is maintained by an employer for employees. A cafeteria plan gives employees the opportunity to choose among a menu of benefits consisting of cash (for example, regular pay) and certain nontaxable benefits (for example, health insurance). A cafeteria plan is not a typical employee benefit plan—instead of providing benefits directly to employees, it serves as a vehicle for employees to elect benefits under other plans and to finance their elections.

2. What is the main advantage for employees if an employer decides to offer a cafeteria plan?

Tax savings is the main benefit for employees. A cafeteria plan allows an employee the opportunity to pay for certain qualified benefits with pre-tax dollars. Qualified benefits under a cafeteria plan are generally not subject to Social Security and Medicare taxes (FICA), federal unemployment tax (FUTA), or federal income tax (FIT). However, certain benefits such as the value of employer-provided group-term life insurance that exceeds \$50,000 of coverage is subject to FIT and FICA taxes, but not FUTA tax. Moreover, as with employees, cafeteria plans also offer tax savings for employers. The extent to which an employer will experience tax savings and other advantages depends on the type of plan, the nature of the workforce, and in some cases, state and local laws.

3. How is a cafeteria plan funded?

Employer contributions to a Cafeteria Plan are usually made directly by an employer and/or pursuant to salary reduction agreements between an employee and the employer in which the employee agrees to contribute a portion of his or her salary on a pre-tax basis to pay for the qualified benefits. Since salary reduction contributions are not actually received by the employee, those contributions are not considered wages for federal income tax purposes. Plus, the contributions generally are not subject to FICA and FUTA taxes.

4. Can a small employer with less than 10 employees sponsor a cafeteria plan?

Yes. Any employer with employees subject to U.S. income taxes can sponsor a Section 125 cafeteria plan, regardless of size. For this purpose, an employer can include private employers, corporations (Subchapter S or Subchapter C), partnerships, nonprofit

organizations, limited liability companies (LLCs), limited liability partnerships (LLPs), sole proprietorships, and government employers.

5. If Company A and Company B are both owned by the same person, can these companies (that are part of a controlled group) provide one cafeteria plan to both of their employees?

Yes. Businesses that are under common control or part of a controlled group or affiliated service group can choose to provide a single plan for all of their employees, or several plans which vary among the business entities, location or other bona-fide employment classifications.

6. In order to sponsor a cafeteria plan, does the employer have to have a formal written plan document?

Yes. The Internal Revenue Code requires that a Section 125 cafeteria plan be in writing prior to the plan's effective date.

7. In July, an employer switches to a new health insurer with a different policy year. When the employer changes its cafeteria plan, must the employer still have a 12-month plan year starting in July?

No. While the regulations, in general, require that a plan have a plan year that is 12 consecutive months, they do allow a for a short plan year; but, only for valid business purposes. Under the circumstances, a short plan year is okay when an employer changes its cafeteria plan year after switching to a new health insurer with a different policy year. This is considered a valid business purpose. However, a plan can never change its plan year if the principal purpose of the change is to circumvent the requirements of Section 125.

8. What information must the cafeteria plan document include?

The formal cafeteria plan document must include the following information:

- Description of available benefits;
- Participation rules;
- Election procedures;
- Manner of contributions;
- Maximum amount of contributions;
- The plan year;

- Ordering rules for use of non-elective and elective PTO or vacation days (if applicable);
- Provisions complying with additional FSA requirements (if applicable); and
- Provisions complying with grace period or carryover rules (if applicable).

9. If a cafeteria plan fails to operate in accordance with the written plan document, will the participants face penalties even though the failure to comply was caused by the plan sponsor and not by the participants?

Yes. The penalty for failing to comply with the Section 125 requirements could be severe — including the imposition of income taxes against participants, employment taxes against the employer and employees, and penalties for failing to withhold and report taxes properly. The 2007 proposed cafeteria plan regulations make it clear that an operational or documentation error can cause the entire Section 125 cafeteria plan to be disqualified. Under the regulations, a plan that fails to operate in accordance with its terms or otherwise fails to comply with the Internal Revenue Code or regulations "is not a cafeteria plan and employees' elections between taxable and nontaxable benefits result in taxable income to employees." Thus, a mistake under a Section 125 cafeteria plan covering thousands of employees could result in taxable income to all participants. Moreover, errors in violation of ERISA, COBRA, and HIPAA can expose a sponsor to damages from private lawsuits as well as penalties.

10. Can an employer perform nondiscrimination testing during the plan year?

According to the Section 125 regulations, testing must be performed as of the last day of the plan year, taking into account all non-excludable employees who were employees on any day during the plan year. Since testing looks at the last day of the plan year, and since changes to the plan generally may not be made after the end of the plan year, it is recommended that testing be performed not only at the end of the plan year (as required), but also at various times throughout the year, to ensure that the plan is satisfying the various nondiscrimination tests. This will help the plan remain in compliance with the nondiscrimination rules and avoid any negative taxation consequences for highly compensated individuals and/or key employees.

11. If two or more companies are owned by the same parent company, will the employees of all those companies be included in the nondiscrimination testing?

The controlled group and affiliated services group rules of IRC Section 414(b), (c), and (m) are expressly applied to Section 125 nondiscrimination. This means that all

employees of a controlled group (i.e., those businesses or companies that are under common control) or affiliated service group will be included in the testing.

12. What civil penalties do employers face if their plans are found to be discriminatory?

There are no specific civil penalties associated with a nondiscrimination testing failure. However, there will be adverse tax consequences for a discriminatory plan, particularly for the highly compensated individuals. If a cafeteria plan fails any of the nondiscrimination tests, then the highly compensated individuals and “key” employees, as applicable, will lose the favorable tax treatment that the cafeteria plan otherwise provides. In other words, the tax-free treatment of benefits provided under the plan will be lost, and highly compensated individuals and key employees will have imputed income equal to the taxable benefit amount that they could have elected to receive for the plan year, even if they elected all non-taxable benefits. So highly compensated individuals and keys that make salary reductions will be taxed on the amount of those salary reductions. The employer should treat the amount as taxable income for purposes of Form W-2 wage reporting and for purposes of income tax, FICA and FUTA withholding.

A discriminatory plan, however, will not affect the favorable tax treatment conferred upon the non- highly compensated individuals under the plan. In addition, the cafeteria plan may still be a valid Section 125 plan even if it is discriminatory.

13. How does FMLA affect cafeteria plans?

While on Family and Medical Leave Act (FMLA) leave, employees must be permitted to continue to receive the same health benefits they had as active employees. An employee must also be permitted to drop health coverage during an FMLA leave and reinstate coverage upon return from an FMLA leave. An employee on FMLA leave must be permitted to either continue coverage under a health FSA or revoke an existing health FSA election for the remainder of the coverage period. Such an employee also has the right to elect to be reinstated in the health FSA upon return from FMLA leave on the same terms as prior to the leave. A special rule applies to the employee’s health FSA election. If the employee suspends participation in the health FSA during the FMLA leave, upon return the employee must be permitted to reinstate either the previous annual election amount or an amount that is reduced on a pro-rata basis (e.g., 10/12 of the annual amount if participation is suspended for a two month leave period).

A cafeteria plan may offer to an employee on unpaid FMLA leave one of three options to continue health benefits while on leave: prepayment, pay-as-you-go, or catch-up. An

employee on paid FMLA leave must be allowed to pay his or her share of premiums by the method normally used during any paid leave.

An employee's entitlement to non-health benefits under a cafeteria plan while on FMLA leave is determined by the employer's established policy for providing such benefits while the employee is on non-FMLA leave.

Eligibility and Benefits

14. Who is eligible to participate in a cafeteria plan?

A Section 125 cafeteria plan may extend participation only to current and former employees of the employer. The definition of "employees" generally includes common-law employees and former common-law employees. Leased employees and full-time life insurance salespersons who are statutory employees are eligible to participate as well as nonresident aliens receiving U.S.-source income (although restrictions may apply).

15. If an employer offers a cafeteria plan that includes health care benefits for spouses and dependents, does that mean that an employee's spouse and his or her child are considered participants under the health plan?

No. Individuals who are not eligible to participate in the Section 125 cafeteria plan include spouses and dependents. The employee may elect coverage on their behalf, but the spouse or dependent does not have a right to make an independent election under the plan.

16. Can the owner or a sole proprietor of small business participate in a Section 125 cafeteria plan?

Self-employed individuals are not considered employees and thus, cannot participate in a Section 125 cafeteria plan. A self-employed individual includes a sole proprietor, a partner in a partnership or a director serving on a corporation's board of directors who does not provide services to the corporation as an employee.

While sole proprietors cannot directly participate in a cafeteria plan, they may legitimately employ their spouse and offer the spouse the benefits of the plan. In such instances, the employer must take care to ensure that the plan is offered on a non-discriminatory basis. A partnership operates much like a sole proprietorship. While the partners cannot directly participate, they may employ a spouse who in turn may receive benefits.

Special rules apply to a more-than-2% shareholder of a Subchapter S Corporation. These individuals may not participate in the plan; nor may their employee-spouse, children, parents, or grandparents. In determining the status of an individual that becomes or ceases to be a more-than-2% shareholder during the course of the S Corporation's taxable year, the individual is treated as a more-than-2% shareholder for the entire year.

Partners in Limited Liability Partnerships (LLPs) and members of Limited Liability Corporations (LLCs) are generally considered self-employed and not eligible to participate in a cafeteria plan (common law-employees of these employers may participate.)

17. If an employee also serves on the employer's board of directors, is that employee ineligible to participate in the employer's cafeteria plan as a result of the fact the employee's status as a director?

No. There is a special rule for certain "dual-status" individuals. Under the dual-status rule, an individual who is an employee of an employer and also provides services to the employer as a director is eligible to participate in the employer's cafeteria plan, although solely in his or her capacity as an employee. The dual-status rule does not apply to partners or more-than-2% shareholders in a subchapter S corporation.

18. What is a qualified benefit?

According to the language of Section 125, a "qualified benefit" is any benefit not includible in the gross income of an employee because of a specific exclusion in the Internal Revenue Code. Cafeteria plan rules list numerous specific benefits as benefits that can be offered through a cafeteria plan. Benefits that are not specifically allowed within the Code cannot be offered.

Some of the most common permissible benefits include the following:

- Coverage under a group accident or health plan.
- Health, dependent care, and adoption FSAs (but not medical savings accounts).
- An accidental death and dismemberment insurance policy.
- Disability coverage under short-term disability and long-term disability policies.
- Dependent care assistance benefits.
- Employer provided adoption assistance benefits.
- Health savings accounts (HSAs).

The above list is not exhaustive. For a complete list of benefits that are considered a “qualified benefit”, please refer to GBS’ Executive Summary on cafeteria plans.

19. Can an employer include transportation benefits within its cafeteria plan, thus allowing the employees to pay for these benefits with pre-tax dollars?

No. Transportation benefits (other than bicycle commuter benefits) may be offered on a pre-tax basis, but may not be included under a cafeteria plan. A separate transportation benefit plan is required.

20. Can the employer offer group term life insurance coverage under a cafeteria plan for an employee’s spouse or an employee’s children?

No. An employer cannot offer group term life insurance for an individual other than the employee. Life insurance coverage other than group term life insurance on employees may not be included under a cafeteria plan, not even on an after-tax basis.

21. Can the employer offer employees the opportunity to purchase paid time off (PTO) through a Section 125 cafeteria plan?

Yes. A cafeteria plan could give employees the opportunity to elect either more PTO (or vacation) days, by purchasing them through the cafeteria plan, or fewer PTO days, by selling them through the cafeteria plan and receiving cash instead. If PTO days are unused, an employee may be allowed to cash them out before the end of the plan year, or the end of the employee’s tax year (whichever is earlier), but may not carry them over into a subsequent year.

22. Can an employer offer (and reimburse) public Marketplace related coverage within its cafeteria plan?

Generally, no. Coverage offered through a public Marketplace established under healthcare reform cannot be reimbursed or paid for under a cafeteria plan, except where a Marketplace-eligible employer (generally a smaller employer) offers employees the opportunity to enroll through a public Marketplace in a qualified health plan in the group market. Employees may not pay premiums on a pre-tax basis through a cafeteria plan for individual coverage, including individual coverage offered through a public Marketplace.

23. Rather than having employees forfeit any unused elective contributions, can employers construct a cafeteria plan that allows employees to carry over any unused elective contributions from one year to purchase benefits the next year?

No. Section 125 provides that a cafeteria plan can not include any plan that provides for deferred compensation. As such, a plan cannot permit employees to carry over unused elective contributions, after-tax contributions, or plan benefits from one plan year to another. This is the case regardless of how the contributions or benefits are used by the employee in the subsequent plan year (for example, whether they are automatically or electively converted into another taxable or nontaxable benefit in the subsequent plan year or used to provide additional benefits of the same type). Similarly, a cafeteria plan also defers compensation if the plan permits employees to use contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year (for example, life, health or disability if these benefits have a savings or investment feature, such as whole life insurance).

24. Does Section 125 prohibition against deferred compensation apply to plans and policies that have a deferred compensation feature?

No. The prohibition against deferred compensation does not apply to specific benefits identified by the Internal Revenue Code that have elements of deferred compensation. The most popular benefits that can be offered in a cafeteria plan and that have elements of deferred compensation are as follows:

- Benefits provided under a Section 401(k) plan.
- An LTD policy paying benefits over more than one plan year.
- Salary reduction contributions in the last month of a plan year used to pay accident or health insurance premiums for the first month of the following plan year.

The above list is not exhaustive. For a complete list of benefits that are allowable even though they have elements of deferred compensation, please refer to GBS' Executive Summary on cafeteria plans.

Election Rules

25. When Can Employees Change Their Elections?

Participants in a section 125 cafeteria plan must be given the opportunity at least annually to make or change elections. This is typically during an open enrollment period. However, a Section 125 cafeteria plan is not required to allow midyear changes.

At a minimum, a Section 125 cafeteria plan must permit certain individuals who qualify for HIPAA Special Enrollment Rights to enroll in medical coverage. However, the Section 125 cafeteria plan may be designed so that the individual must pay for the coverage on a post-tax basis outside of the Section 125 cafeteria plan until the next enrollment period.

Additionally, upon the decision of the plan sponsor and provision in the plan document, a Section 125 cafeteria plan may permit midyear changes based on the following events:

- Change in status (including marital status, number of dependents, employment status, dependent ceases to satisfy eligibility requirements, change in residence, or adoption)
- Insignificant change in cost with an automatic increase or decrease to employee contributions
- Significant cost changes
- Significant curtailment in coverage (including loss of coverage, increase in copayments or increase in coinsurance)
- Addition or significant improvement of benefit options
- Change in coverage under other employer plan
- Revocation as a result of an expected reduction in hours of service below 30 hours per week that does not affect plan eligibility
- Revocation during the Marketplace open enrollment period to purchase a Qualified Health Plan through the Marketplace
- Revocation during a Marketplace special enrollment period to purchase a Qualified Health Plan through the Marketplace
- Loss of group health coverage or coverage under certain government or educational institution plans.
- Entitlement to Medicare or Medicaid
- Leave of absence under the Family and Medical Leave Act or the Uniformed Services Employment and Reemployment Rights Act

If the plan receives a judgment, decree or order requiring coverage for an employee's dependent child, such as a Qualified Medical Child Support Order (QMCSO), the plan should allow the addition of coverage. However, as with the HIPAA Special Enrollment Rights, the plan may decide that the individual must pay for the coverage on a post-tax basis outside of the Section 125 cafeteria plan until the next enrollment period.

The change in election must be consistent with the event, and the plan may allow "tag-along" changes for existing spouses and dependent children for certain permissible

election changes. Note: the change in cost or coverage rules are not available for a health FSA.

26. When can an employee make an election change on a retroactive basis?

If the employee has a change in status as a result of the birth or adoption (including placement) of a child and makes an election change on a timely basis, coverage may be added retroactively. HIPAA requires retroactive coverage in the event of birth or adoption as long as the new election is made within a 30-day HIPAA special enrollment period. The IRS's cafeteria plan regulations state that in the event of birth or adoption, the pre-tax election (to pay for the additional coverage) may also be retroactive to the date of the birth or adoption (to dovetail with the coverage requirements under HIPAA).

In the event of a new hire, IRS rules permit a limited 30-day enrollment window so that if the employee makes an election within this window period, the pre-tax cafeteria plan election to pay for the coverage may be retroactive to the date of hire (presuming the underlying health plan document and insurance contract allow for this as well).

27. If the employee has a change in status as a result of a marriage and makes an election change on a timely basis, can coverage be added retroactively so that the employee pays for the coverage with pre-tax dollars?

No. In the vast majority of circumstances, a mid-plan-year change of a pre-tax cafeteria plan election must be prospective. For example, if an employee who has single coverage marries on August 1 and elects family coverage on August 22, his/her increased pre-tax payroll reduction election would begin no earlier than August 22. The effective date of the family's coverage under the health plan would depend on the terms of the plan document and insurance contract. If the plan document and insurance contract permit retroactive coverage, then the employee's contribution for the retroactive portion of increased coverage must be paid for on an after-tax basis. In the above example, if the health plan document and insurance contract permit retroactive additional coverage (for the family), the employee's family coverage would begin on August 1, and the increased contribution for family coverage from that date to August 21 would be paid for on an after-tax basis, then the increased coverage for the period from August 22 forward could be paid for on a pre-tax basis through the cafeteria plan.

28. If an employee has a change in status that results in a decrease in coverage – such as divorce – and makes a new election on a timely basis what is the effective date of the termination?

The date of termination of coverage will be determined by the terms of the health plan document and the underlying insurance contract. The health plan document and insurance contract may provide that coverage ends on the date of the divorce or it may provide that the coverage continues until the end of the month. Similarly, the date on which the pre-tax contribution ends depends on the terms of the cafeteria plan document (governed by IRS cafeteria plan regulations), and should dovetail so that the pre-tax contribution ends at the time the health plan coverage ends.

29. What options does an employee have if the employee did not make an election within the 30-day (or 60-day for certain events) HIPAA special enrollment time period?

The employee would be able to make a new election during the next annual enrollment period. The employee would also be able to make a new election if the employee experiences another change in status during the plan year (assuming that the cafeteria plan and insurance contract (if applicable) permit it), however, the new election must be “consistent” with the new change in status as defined by IRS cafeteria plan rules.

30. What election changes are permitted when an employee’s child becomes eligible for coverage under a state children’s health insurance program (CHIP)?

Gaining eligibility for CHIP would not permit an employee to reduce the pre-tax cafeteria plan contribution to drop health coverage – the employee would not be able to reduce the pre-tax contribution to drop coverage until the next annual enrollment. Loss of eligibility for CHIP or a gain of eligibility for state premium assistance under a CHIP would be a HIPAA special enrollment that would permit the employee to make a new pre-tax election to add coverage under the health plan.

31. Employee is married and has one daughter. Employer’s plan offers coverage for – employee only, employee plus one dependent and family coverage. Employee divorces during the year and the employee wants to change her family medical coverage election. What options are available to the employee?

Employee may change election to employee plus one dependent coverage and drop coverage for her spouse who has lost eligibility. However, the employee cannot change election to completely drop coverage since her election would not satisfy the consistency rule because neither the employee, nor her daughter lost eligibility under

the plan. (Note: if the child is the employee's stepchild and loses eligibility as the result of the divorce, the employee would be able to drop coverage for the child.)

The general consistency rule includes two elements that must be met: (1) the change in status event must affect eligibility for coverage under an employer's plan; and (2) the election change must be on account of, and correspond with, the event. The regulations clarify that "a change in status that affects eligibility under an employer's plan" includes a change in status that results in an increase or decrease in the number of an employee's family members or dependents who may benefit from coverage under the plan.

32. Employer's plan offers three medical options – a PPO plan, HMO #1, and HMO #2. The two HMOs have different service areas. Employee resides in the service area covered by HMO #1. Employee moves from a location that is in HMO #1's service area to a location that is in HMO #2's service area. What are the employee's options with respect to changing elections?

The employee may select coverage under either HMO #2 or the PPO plan, or the employee may cancel medical coverage.

33. Employee and his spouse each have single health coverage under their respective employer's plans. Employee also has a \$600 health FSA with his employer. The spouse terminates her employment and loses coverage during the year. Can the employee change his family coverage under his plan and increase his health FSA election?

Yes. The employee may change his election to family coverage under his employer's plan and may increase his health FSA election.

34. Employee's plan enables him to purchase up to \$50,000 of group term life insurance on a pre-tax basis. Employee selected \$10,000 of coverage. If the employee gets divorced during the year, can he change his election?

Yes. The employee may either increase or decrease his group term life coverage. In the case of group term life coverage and disability coverage, the regulations specify that, for any status change events, elections either to increase or decrease group term life, disability, and dismemberment coverage are deemed to satisfy the consistency rule. Since these types of coverage are designed to provide income (rather than expense reimbursement), upon a status change event "it may be appropriate for the employee to seek to increase or decrease the coverage."

35. Employee makes election during open enrollment. Subsequently, employee wants to change his election during the year. In order to do so, employee arranges with his employer to terminate employment and resume his job one week later. Can employee change his election?

No. The employee does not have a change status that would permit him to change his elections, since the principal purpose of the termination of employment was to change cafeteria plan elections. The IRS, in an example indicated that coverage can be cancelled during a period of unemployment and reinstated upon return if the period of unemployment is 30 days or less. If the period of unemployment is more than 30 days, the employee may make a new election without another status change.

36. An employee, a single parent with one child, elects \$4,000 under her dependent care FSA. When the child turns age 13 during the year, can the employee cancel participation in the dependent care FSA?

Yes. The employee can drop dependent care FSA participation when her child reaches age 13 because that child reached the limiting age.

37. Employee is married and has one child. Employer offers employee only, employee plus 1 dependent, family, or no coverage options under its health plan. Employee chooses single health coverage. Employee divorces spouse during the year and employer's plan receives a QMCSO requiring employee to cover the child. Can employee change his election?

Yes. Employee can change his election to employee plus 1 dependent health coverage to provide coverage to his child as required under the QMCSO.

38. Employee has employee plus 1 dependent coverage under a PPO medical plan. The PPO medical plan has employee-only, employee plus 1 dependent, and family coverage levels. A new HMO is offered in the middle of the year. The HMO has employee-only or family coverage levels. The employee wants to change her election from employee plus 1 dependent in the indemnity plan to family HMO coverage. Can she?

Yes. The HMO is a new benefit option. The employee may change her election to family coverage under the HMO plan. However, the employee is not permitted to select employee-only coverage under the HMO plan and is not permitted to change her health FSA election.

Flexible Spending Accounts (FSAs)

39. What is a Flexible Spending Account?

Flexible Spending Accounts (FSAs) fall under Internal Revenue Code Section 125, due to their special tax treatment. There are three types of FSAs: health, dependent care, and adoption assistance. The purpose of FSAs is to allow certain expenses to be paid by the employee with pretax dollars.

A health FSA reimburses health, vision, and dental expenses that are not covered by insurance. A dependent care FSA reimburses qualifying child care expenses. Adoption assistance FSA reimburses qualifying adoption expenses.

With FSAs, the employee elects to defer a certain dollar amount tax-free each plan year into his or her account. When expenses that qualify for reimbursement occur, the employee submits claims to his or her FSA administrator, and the amount is paid out without being taxed. In some cases an employer may also contribute to an FSA.

40. Can an employee who contributes to both health and dependent care FSAs use money in one account to pay for expenses from the other?

No. The Internal Revenue Service (IRS) requires that employees keep the two accounts separate.

41. Are dependent care FSAs and health FSAs subject to a maximum dollar amount?

Yes. For health FSAs, the employer determines the minimum and maximum amounts, but the maximum salary reduction contribution for the health FSA is limited to \$2,700 (for 2019, will be indexed in the future). The employer may also make a contribution to the employee's health FSA, and that amount will not count toward the \$2,700 (as indexed salary reduction cap.) The \$2,700 maximum applies on a per employee basis; if a husband and wife are each eligible to contribute to a health FSA through either the same or different employers, each may be able to contribute up to \$2,700.

For dependent care FSAs, the annual maximum is the smallest of: \$5,000, per calendar year for married individuals who file a joint federal income tax return and single parents, \$2,500 for married individuals who file separate federal income tax returns, and the earned income of either parent if less. A special rule apply if either spouse is a full-time student or disabled. The \$5,000 maximum for married individuals applies even if the spouses have access to separate dependent care FSAs as employees of the same or different employers. Note: dependent care FSA maximums are not indexed.

42. If the employee uses up all the money in his FSA before the end of the year, can he or she contribute more?

No. Employees can only change the FSA election amount as the result of a permitted change in status, such as marriage, divorce or the birth of a child. And, under no circumstances, can employees exceed the relevant maximum contribution amount.

43. Can an employee use an FSA to prepay for expenses, as long as the employee submits appropriate documentation within a reasonable time?

No. FSA can only reimburse employees for expenses that have been incurred. Expenses are incurred at the time that the service or item is provided, not when the employee is formally billed or pays for the service. Thus, employers may not reimburse employees in advance for services not yet rendered. Actual reimbursements, however, may be made after the period of coverage has ended. Employers should specify in the written plan document the date by which employees must submit claims for each plan year.

44. What happens to unused amounts in an employee's FSA when employment is terminated?

COBRA continuation rules apply to health FSAs for employers subject to COBRA. How the remaining balance at termination is treated depends on whether the employee elects or waives COBRA continuation coverage. If the employee elects COBRA, he or she is required to remit the monthly required contribution directly, since payroll deductions can no longer occur. This requires paying after-tax dollars to participate in the health FSA. If COBRA is elected, then the period of coverage for that employee continues and the employee can continue to submit claims.

If COBRA is waived, then only claims for services incurred before the termination date can be submitted for reimbursement. If COBRA is waived, then the unused portion of the account is forfeited after all claims incurred prior to separation have been submitted.

Amounts remaining in a dependent FSA are generally forfeited following the end of the plan's claim run-out period. The claim run-out period is typically 30-90 days following termination of employment.

Health FSA

45. Does the prohibition of deferred compensation apply to health FSA plans?

Cafeteria plans may permit a carryover of up to \$500 of unused health FSA funds, assuming that certain conditions are satisfied. The carryover of up to \$500 may be used

to reimburse medical expenses under the health FSA incurred during the entire plan year to which it is carried over. For this purpose, the amount remaining unused as of the end of the plan year is the amount unused after medical expenses have been reimbursed at the end of the plan's run-out period for the plan year. In addition to the unused amounts of up to \$500 that a plan may permit an individual to carry over to the next year, the plan may permit the individual to also elect up to the maximum allowed salary reduction amount. Thus, the carryover of up to \$500 does not count against the indexed \$2,700 salary reduction limit (as of 2019) applicable to each plan year. Although the maximum unused amount allowed to be carried over in any plan year is \$500, the plan may specify a lower amount as the permissible maximum. And, of course, the plan sponsor has the option of not permitting any carryover at all. If an employer decides to adopt a carryover, the same carryover limit must apply to all plan participants.

46. Can a cafeteria plan make advance reimbursements for medical expenses?

No. Employees can be reimbursed only for allowable, documented expenses incurred during the plan year, after the expenses have been verified. There is, however, a limited exception for orthodontia expenses. Many orthodontists charge an initial upfront fee and then require payment in installments over the course of the treatment and it may be difficult to match payments and treatments. In 2007 proposed regulations the IRS indicated that orthodontia expenses may be reimbursed once the employee has actually paid the billed amounts. Since the proposed regulations did not address other types of expenses that may be billed in a similar manner (e.g., prenatal care), the conservative approach is to reimburse expenses after the care has been provided even if the provider bills some portion of the fee upfront.

47. If the employee's child turns 18 this year, can the employee use the health FSA for expenses associated with that child?

Yes. For medical accounts, the general rule is that if you can claim an individual as a dependent on your tax return, then you can claim them under the cafeteria plan. Note that under PPACA, the expenses of a child under the age of 27 as of the end of the tax year may be reimbursed tax free from a health FSA, even if the child does not qualify as a tax dependent for an employee.

48. Can an employee use a health FSA to pay for health insurance premiums?

No. Generally, a health FSA may reimburse only medical expenses that are deductible under Internal Revenue Code section 213. Among others, these include medical, prescription drug, dental, vision, hearing and other types of healthcare expenses. Health

FSA's cannot be used to reimburse the following: health insurance premiums, cosmetic surgery, and long term care insurance premiums.

49. Does an employer have any flexibility in structuring a health FSA plan to allow employees to use unused funds after the plan year end?

Employers have some flexibility. In general, a cafeteria plan may not allow employees to defer compensation that is earned in one year to the next. Amounts not used to reimburse eligible expenses incurred during the year must be forfeited. This is called the "use it or lose it" rule. Therefore, employees may not carry over unused elective contributions or plan benefits from one plan year to the next. Employers, however, may have a "run-out" period after the plan year's ends that allows employees to submit claims for eligible expenses that were incurred during the plan year. However, there are two exceptions to the use it or lose it rule. First, the plan may include a grace period that allows employees to incur claims for up to 2.5 months after the end of the plan year, and submit them against the prior year's balance for reimbursement.

Second, the health FSA may include a provision that allows the employee to carry over to the immediately following plan year of up to \$500 of any amount remaining unused as of the end of the plan year. The carryover of up to \$500 may be used to pay or reimburse medical expenses under the health FSA incurred during the entire plan year to which it is carried over. For this purpose, the amount remaining unused as of the end of the plan year is the amount unused after medical expenses have been reimbursed at the end of the plan's run-out period for the plan year. Any carryover amount does not count toward the indexed \$2,700 (for 2019) salary reduction limit applicable to each plan year. Although the maximum unused amount allowed to be carried over in any plan year is \$500, the plan may specify a lower amount as the permissible maximum. If an employer decides to adopt a carryover, the same carryover limit must apply to all plan participants. However, a plan adopting this carryover provision is not permitted to also provide a grace period with respect to health FSA's.

50. If the health FSA includes employee forfeitures (i.e., unused employee contributions) at the end of the plan year, or any applicable run-out period, grace period, or after a carryover is applied, what can an employer do with the forfeited amount?

Most employers use forfeitures to offset plan costs. Employers have some flexibility in determining how to use forfeited amounts as long as the IRS rules are followed and ERISA plan asset rules for health FSA's subject to ERISA. Employers may give forfeitures to participating employees. For example, if the total forfeitures under the health FSA are \$1,000 and there are 100 participating employees, the employer could

give each participating employee a \$10 (taxable). However, amounts paid to any employee may not be determined based on the amount the employee forfeited.

51. If an employee's domestic partner is covered under the employee's insurance plan, can the employee use his or her FSA for the domestic partner's medical expenses?

It depends. If the domestic partner meets the IRS qualifications of a tax dependent, the employee can legally use his FSA funds for the domestic partner's medical expenses. If the domestic partner doesn't meet the qualifications, the employee cannot receive reimbursements from his health FSA for expenses incurred by the domestic partner.

52. Can an employee contribute in an HSA if they are covered by a general purpose health FSA solely as a result of a carryover from a previous FSA?

No. An employee cannot contribute to an HSA if covered by an FSA (unless the health FSA is designed to be HSA-compatible). This rule applies even if the employee is enrolled in the FSA solely as a result of carryover amounts from a previous FSA.

53. If the carryover amounts are depleted during the carryover year, can an employee then contribute to an HSA during the same plan year?

No. An employee is still not permitted to contribute to an HSA for the months following the depletion of FSA funds for the rest of the plan year.

An employee can elect to decline or waive any carryover amounts prior to the beginning of the plan year; in which case, the employee may be eligible to contribute to an HSA.

54. Can an employer automatically enroll an employee in an HSA-compatible FSA if the employee elects to enroll in a high deductible health plan and an HSA?

Yes, an employer is permitted to automatically enroll an employee in an HSA-compatible FSA for the upcoming plan year if the employee elects to enroll in a high deductible health plan and an HSA for the same year.

Dependent Care FSA

55. Can a dependent care FSA reimburse employee expenditures for babysitter services?

It depends. Eligible expenses under a dependent care FSA are defined as those that enable the employee and his or her spouse to work or look for work. These include payments to child care centers that care for 6 or more children and meet the IRS' definition of a qualified day care center, caregivers for a disabled spouse or dependent

who lives with the employee, and babysitters, nursery schools and household expenses if a portion of the expense is incurred to ensure a qualifying dependent's well-being and protection. If the expense is not incurred for the purpose of allowing the employee and his or her spouse to work or look for work, then the expense cannot be reimbursed from the dependent care FSA. Expenditures that may not be reimbursed from a dependent care FSA include babysitting for social events, educational expenses, overnight camp, and expenses that the employee will take as a child care tax credit on his or her income tax return.

56. Employee has one child who is enrolled in a day care center for preschool children. The annual cost of the program is \$3,000. Employee elects a \$3,000 dependent care FSA to cover the cost of the child's day care. Employee finds a new day care provider at a different cost. Can the employee change her dependent care FSA election amount to match the cost of the new provider?

Yes.

57. Can an employee use his dependent care FSA to care for his 18 year old son?

Probably not. A dependent care FSA can only be used to reimburse expenses for eligible dependents. An eligible dependent is any dependent for which an employee pays a provider to care for him/her while they are at work or looking for work. The dependent must be under the age of 13 or incapable of taking care of themselves, and live in the employee's home for more than half of the year. As such, expenses associated with an employee's 18 year old son would not qualify, unless the son is incapable of taking care of himself, and lives in the employee's home for more than half of the year.

58. If the employee's child turns 13 this year, can the employee use the dependent care account for the whole year?

No. The employee can only submit claims for reimbursement for expenses incurred before her child reaches the age of 13.

59. An employer has a cafeteria plan, which offers dependent care assistance, and an employee's benefits exceed \$5,000. How is this reported on a W-2 Form?

Generally, an employee can exclude from gross income up to \$5,000 of benefits received under a dependent care assistance program each year. For married employees, filing separate claims, the limit is reduced to \$2,500 each. The exclusion cannot exceed the earned income of either the employee or the employee's spouse. The total dependent care benefits the employer paid to the employee or incurred on the



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behalf of the employee (including amounts from a Section 125 plan) should be reported in Box 10 of Form W-2. Amounts over \$5,000 must also be included in Boxes 1, 3, and 5, as "wages," "social security wages" and "Medicare wages".