

COMPLIANCE OVERVIEW

Provided by Boyd Consulting Group

Section 125: Cafeteria Plan Common Questions

A Section 125 plan, or a cafeteria plan, allows employers to provide their employees with a choice between cash and certain qualified benefits without adverse tax consequences. Employees who participate in a cafeteria plan can pay for qualified benefits, such as group health insurance, on a pretax basis. This reduces both the employees' and the employer's tax liability.

Once an employee makes a cafeteria plan election, he or she may not change that election until the next plan year, unless the employee experiences a permitted election change event. This irrevocability requirement can be a disadvantage to participating in a cafeteria plan. Also, while the employer may reduce its tax liability by offering a cafeteria plan, it is responsible for the costs of establishing and maintaining the plan.

Also, to receive the tax advantages associated with a cafeteria plan, the plan must generally pass certain tests that are designed to ensure that the plan does not discriminate in favor of highly compensated employees.

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

EXAMPLES OF QUALIFIED BENEFITS

- Medical plan coverage
- Dental and vision coverage
- Health FSAs
- Dependent care FSAs
- HSAs
- Life insurance coverage
- Disability benefits

NONDISCRIMINATION TESTS

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

- The eligibility to participate test;
- The benefits and contribution test; and
- The key employee concentration test.

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WHO IS ELIGIBLE TO PARTICIPATE IN A SECTION 125 PLAN?

While there are some exceptions, generally, an employer can define which classes of employees and former employees are eligible to participate in a Section 125 plan. Some employers impose a waiting period before new employees are eligible to participate. In addition, some employers allow employees to participate in the Section 125 plan immediately, but impose a waiting period on participation on the flexible spending account (FSA) portion of the Section 125 plan.

The Section 125 rules specifically prohibit the following individuals from participating:

- Self-employed individuals;
- Partners within a partnership; and
- More than 2 percent shareholders in a subchapter S corporation (S corporation).

Self-employed individuals, partners and more than 2 percent shareholders in an S corporation (or their business entities) may sponsor a Section 125 plan for their employees. Under the ownership attribution rules of Internal Revenue Code (Code) Section 318, however, the spouse, children, parents and grandparents of a more than 2 percent shareholder cannot participate in the S corporation's Section 125 plan.

CAN FORMER EMPLOYEES ELECT COBRA AND CONTINUE TO PARTICIPATE IN THE SECTION 125 PLAN?

Generally, COBRA participants receiving severance pay may be permitted to continue to make pretax contributions toward the cost of insurance.

WHAT ARE THE ADVANTAGES FOR EMPLOYEES TO PARTICIPATE IN A SECTION 125 PLAN?

Employees who participate in a Section 125 plan receive the following advantages:

- An employee realizes an increase in his or her spendable income by:
 - Paying his or her portion of insurance premiums with pretax dollars; and
 - Paying out-of-pocket medical expenses with pretax dollars set aside in an FSA.
- Where an employer offers a full cafeteria plan, an employee is provided an opportunity to elect only those benefits that he or she deems most valuable.

WHAT DISADVANTAGES SHOULD AN EMPLOYEE CONSIDER BEFORE ELECTING TO PARTICIPATE IN A SECTION 125 PLAN?

Before an employee elects to participate in a Section 125 plan, he or she should be aware of the following disadvantages. First, an employee may not change his or her elections throughout the plan

year unless he or she experiences a permitted midyear election change event (for example, the birth of a child or marriage). Also, while participation in a Section 125 plan reduces the employee's taxable income, it may also reduce other benefits. Benefits that are calculated using the employee's income (for example, Social Security or retirement benefits) will, in turn, be reduced.

Finally, any unused funds remaining in an FSA at the end of the plan year (or applicable grace period) are lost. There is a narrow exception to this "use-or-lose" rule for Section 125 plans that allow participants to carry over up to \$500 in unused health FSA dollars to the next plan year.

WHAT DISADVANTAGES SHOULD AN EMPLOYER CONSIDER BEFORE CHOOSING TO IMPLEMENT A SECTION 125 PLAN?

Before an employer decides to implement a Section 125 plan, it should consider the following disadvantages. First, while the employer reduces its tax liability, it is responsible for the cost, establishment and maintenance of the plan. Also, employers offering an FSA bear some risk of loss due to the uniform coverage rule.

WHAT ARE THE ADVANTAGES TO AN EMPLOYER THAT ESTABLISHES A SECTION 125 PLAN?

One advantage to an employer that establishes a Section 125 plan is that the employer is able to reduce its tax liability (for example, FICA and FUTA) because employees reduce their taxable income. Also, if an employer offers a full cafeteria plan, the employer may see increased employee satisfaction with employee benefit offerings because employees are provided with an opportunity to direct the employer's contribution to the benefits the employee values most.

WHAT BENEFITS CAN BE OFFERED UNDER A SECTION 125 PLAN?

Benefits that are typically offered under a Section 125 plan include:

- Health;
- Dental;
- Vision;
- Accidental death and dismemberment;
- Short- and long-term disability;
- Group-term life insurance (up to \$50,000 in coverage);
- Health FSAs (to cover out-of-pocket medical expenses not covered by insurance);
- Dependent care FSAs; and
- Health savings accounts (HSAs).

WHAT BENEFITS CANNOT BE OFFERED UNDER A SECTION 125 PLAN?

The following benefits may not be offered under a Section 125 plan:

- Educational assistance plans;
- Transportation fringe benefits;
- Long-term care insurance or services;
- Employer-provided meals and lodging;

- Individual health insurance policies (major medical coverage), either inside or outside of the Exchange. Exchange coverage may be funded through a cafeteria plan only if the employer elects to make group coverage available through the Exchange's Small Business Health Options Program (SHOP);
- Health reimbursement arrangements (HRAs);
- Dependent group-term life insurance; and
- Archer medical savings accounts (Archer MSAs).

DO NONDISCRIMINATION RULES APPLY TO A SECTION 125 PLAN?

Section 125 plans must pass three complex nondiscrimination tests. In general, the tests are designed to determine whether the plan discriminates in favor of key employees or highly compensated individuals (HCIs). They are as follows:

- Eligibility to participate test;
- Benefits and contributions test; and
- Key employee concentration test.

Effective for plan years beginning after Dec. 31, 2010, the Affordable Care Act (ACA) allows certain small employers' cafeteria plans to qualify as simple cafeteria plans if they meet certain specific requirements relating to eligibility, participation and contributions. If these requirements are met, the applicable nondiscrimination requirements of a classic cafeteria plan are treated as satisfied.

A **highly compensated individual** generally includes any individual who is:

- An officer;
- A shareholder owning more than 5 percent of the voting power or value of all classes of stock of the employer;
- Highly compensated; or
- A spouse or dependent of a person described above.

An employee is considered "highly compensated" if he or she had compensation in excess of a specified dollar threshold for the preceding plan year, and, if elected by the employer, was also in the "top-paid group" of employees (that is, the top 20 percent). For 2016 and 2017 plan year testing, the dollar threshold is **\$120,000**.

WHAT IS THE ELIGIBILITY TO PARTICIPATE TEST UNDER SECTION 125?

A plan's eligibility rules may not discriminate in favor of HCIs. The eligibility test looks at whether a sufficient number of non-HCIs are eligible to participate in the cafeteria plan. If too many non-HCIs are ineligible to participate, the plan will fail this discrimination test.

Under the eligibility test, a plan does not discriminate in favor of HCIs if it meets all of the following requirements:

Employment Requirement	The same employment requirement applies to all employees and the plan does not require more than three years of employment to participate.
Entry Requirement	Entry into the plan is not delayed.
Nondiscriminatory Classification Requirement	The plan benefits a classification of employees that does not discriminate in favor of HCIs.

For plan years beginning on or after Jan. 1, 2014, the ACA prohibits group health plans from applying any waiting period that exceeds **90 days**. This ACA provision affects cafeteria plans because employers will generally want to allow employees to pay for their health plan coverage on a pretax basis, starting when they first become eligible for health plan coverage. Thus, employers will typically align their health plan's and cafeteria plan's waiting periods, which means that a cafeteria plan will rarely have a waiting period that exceeds 90 days.

WHAT IS THE SECTION 125 BENEFITS AND CONTRIBUTIONS TEST?

A plan may not discriminate in favor of highly compensated participants as to benefits or contributions. This test is designed to make sure that a plan's contributions and benefits are available on a nondiscriminatory basis and that highly compensated participants do not select more nontaxable benefits than non-highly compensated participants.

Highly compensated participants are HCIs who actually participate in the plan.

A plan will pass or fail the benefits and contributions test based upon the facts and circumstances of each case. The factors the IRS considers when reviewing the facts and circumstances are:

- **Availability.** A plan must give each participant an equal opportunity to select nontaxable (qualified) benefits.
- **Utilization.** The IRS will review whether HCIs elected benefits to a greater extent than non-HCIs. For example, a plan would likely fail this test if benefits were so expensive that only HCIs could afford to elect the benefits.

- **Nondiscrimination in operation.** A plan may not discriminate in favor of HCIs in operation.

WHAT IS THE SECTION 125 KEY EMPLOYEE CONCENTRATION TEST?

Under a Section 125 plan, key employee contributions cannot exceed 25 percent of the total contributions into the plan.

A **key employee** is generally an employee who is:

- An officer whose annual pay exceeds \$175,000 (\$170,000 for 2016); or
- An employee who is either of the following:
 - A 5 percent (or greater) owner of the business; or
 - A 1 percent (or greater) owner whose annual pay is greater than \$150,000.

Only cafeteria plan participants who have elected one or more nontaxable benefits under the plan are included in the testing group. The test is performed by calculating the aggregate nontaxable benefits provided to key employees and the aggregate nontaxable benefits provided to all employees (key employees and non-key employees). Key employees must not receive more than 25 percent of the aggregate nontaxable benefits provided to all employees.