

San Francisco Health Service System Health Service Board

Board Forum

Internal Revenue Service Code: Section 125

November 9, 2017

Today's Discussion

- What is a Cafeteria Plan Section 125?
- Key Requirements of a Section 125 Plan
- Allowable Enrollment and Mid-Year Change Rules
- Non-Discrimination Rules
- Consequences of Non-Compliance

What is a Cafeteria Plan?

- A “cafeteria plan” is a fringe benefit plan that complies with Section 125 of the Internal Revenue Code (tax code)
 - Most health and welfare benefits are delivered via a cafeteria plan
 - Generally allows employees to choose between cash (salary reduction) and benefits, on a tax-advantaged basis
 - Pre-tax dollars are used to pay for benefits (employees’ payroll deduction contributions are pre-tax and employer does not pay payroll tax on pre-tax contributions)
 - **Since benefits are offered pre-tax, the federal government limits the changes employees can make to benefit choices throughout the year**
- Section 125 of the tax code applies even if the Employee Retirement Income Security Act (ERISA) does not

Key Requirements of a Cafeteria Plan

■ Plan Document

- This is a legal document that states how the plan works and defines which benefits are part of the employer's cafeteria plan. This document must be available to employees upon request.
- The plan document is reviewed annually for compliance and is approved by the Health Service Board.

■ Annual Enrollment Period

- Cafeteria plans must allow employees the opportunity to make benefit plan choices every 12 months. Those benefit decisions must be made before the beginning of the plan year.
- Most plans operate on a calendar year, so most annual enrollments occur in October/November for the following year.

■ Mid-year election changes are restricted once the plan year has begun.

Cafeteria Plan Enrollment Rules

- Employers are not required to allow employees to make mid-year elections changes except those under the HIPAA Special Enrollment Rights. An employer should include in the summary plan description which events, if any, would allow for an employee to make mid-year election changes. It is of note that SFHSS has always allowed for special enrollment rights.
- If a change in status does occur, the election changes should be consistent with that event. For example, if an employee divorces, the employee may drop coverage for the spouse.
 - Dependent verification audits are one way to ensure that the plan is covering only those eligible for the plan and when a qualifying life event has occurred, the member's enrollment changes appropriately.

Allowable Mid-Year Election Changes

- Generally speaking, elections for group health insurance are irrevocable for the plan year under Section 125 plans. However, the tax regulations provide narrow exceptions when an employee can make mid-year election changes
 - Changes are normally allowed within 30 days of a “qualifying event,” and may vary by type of plan (health & welfare, spending accounts)
 - “Qualifying events” include gain or loss of a dependent (i.e., marriage, birth, death, divorce); gain or loss of other coverage; certain changes in eligibility or employee status; significant change in cost or coverage

Allowable Mid-Year Election Changes (cont.)

- Change in family status: marriage, divorce, legal separation or annulment; beginning/ending of domestic relationship
- Change in dependent status: birth, adoption, or legal guardianship of a child; death of spouse/domestic partner/child, change in eligibility status
- Change in employment status of employee and/or spouse: new job, stop working, full-time to part-time, or part-time to full-time
- Change in coverage of spouse or dependent under another employer plan: spouse's employer had no insurance coverage before but now offers a plan, gains/loses eligibility, spouse's annual enrollment period.

Allowable Mid-Year Election Changes (cont.)

- Change in residence: employee or dependent moves out of plan service area (generally HMO only)
- Significant cost changes in coverage
- Significant curtailment of coverage
- Loss/entitlement of certain other health coverage: Medicare, Medicaid
- Health Insurance Portability and Accountability Act (HIPAA) special enrollment right events: add/loss of dependent, newly eligible dependent, loss of other group health coverage
- Judgments, decrees or orders
- Entitlement to Medicare or Medicaid
- Enrollment in an Exchange

Non-Discrimination Rules

- The tax code's nondiscrimination rules exist to prevent plans from being designed in such way that it discriminates in favor of individuals who are either highly compensated employees (HCE) or key employees (KEY) in the organization (note that some employees may be both HCE and KEY)
 - Highly Compensated Employees (must meet one criteria):
 - 5% or more ownership of the organization
 - Prior year salary of \$120,000 or more
 - KEY Employees (must meet one criteria):
 - 5% or more ownership
 - 1% or more ownership and salary of \$150,000 or more
 - Officer of the company with prior year salary of \$170,000 or more

Non-Discrimination Rules

- There are three themes to non-discrimination testing:
 - Eligibility: If too many non-HCEs are excluded from participation in the plan, then it will be discriminatory.
 - Availability of Benefit: The plan will not pass the tests if the HCEs/KEYs can access more or better benefits than the non-HCEs/KEYs. This is sometimes called a “Contributions and Benefits Test.”
 - Utilization: A plan will not pass the nondiscrimination tests if the HCEs/KEYs actually elect more benefits under the plan. This is sometimes called a “Concentration Test.”

Consequences of Non-Compliance

- Failure to satisfy Section 125 requirements (including making exceptions to mid-year election change rules) would mean plan disqualification.
- Disqualification results in loss of preferential tax treatment for employees and employer for multiple years
 - Employees' payroll deduction contributions will be treated as taxable income (plus penalties and interest)
 - Loss of employer deduction for contributions
 - Payroll tax liability for both employer and employees

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