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5 Things To Know About Cafeteria Plans

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Benefits Pro

In the days before health care reform, the IRS permitted employers to determine the maximum amount an employee could set aside tax-free in a Flexible Spending Account. But that was then, and this is now.

Going forward, employers will need to enforce a $2,500 annual limit on all employee healthcare FSA contributions.

The Patient Protection and Affordable Care Act also changed the definitions of qualified medical expenses (for FSAs, HSAs, and HRAs) to bring them in-line with the definition used for the medical expenses tax deduction, an itemized deduction, which excludes tax-free reimbursements for over-the-counter drugs not prescribed by a physician.

How else have cafeteria plans changed under the PPACA? Here are five answers to questions that help shed light on the new limitations and requirements on these plans under the law.

1. What benefits may be offered under a cafeteria plan?

Participants in a cafeteria plan may choose among two or more benefits consisting of cash and qualified benefits. A cash benefit includes not only cash, but a benefit that may be purchased with after-tax dollars or the value of which is generally treated as taxable compensation to the employee (provided the benefit does not defer receipt of compensation).

A qualified benefit is a benefit that is not includable in the gross income of the employee because of an express statutory exclusion and that does not defer receipt of compensation. Contributions to Archer Medical Savings Accounts, qualified scholarships, educational assistance programs, or excludable fringe benefits are not qualified benefits. No product that is advertised, marketed, or offered as long-term care insurance is a qualified benefit.

With respect to insurance benefits, such as those provided under accident and health plans and group term life insurance plans, the benefit is the coverage under the plan. Accident and health benefits are qualified benefits to the extent that coverage is excludable under IRC Section 106. Accidental death coverage offered in a cafeteria plan under an individual accident insurance policy is excludable from the employee's income under IRC Section 106. A cafeteria plan can offer group term life insurance coverage on employees participating in the plan. Coverage that is includable in income only because it exceeds the $50,000 excludable limit under IRC Section 79 also may be offered in a cafeteria plan.

Accident and health coverage, group term life insurance coverage, and benefits under a dependent care assistance program remain "qualified" even if they must be included in income because a nondiscrimination requirement has been violated.

For taxable years beginning after Dec. 31, 2012 a health flexible spending arrangement (FSA) under a cafeteria plan will not be treated as a qualified benefit unless the plan provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of $2,500 made to such arrangement. For plan years beginning after Dec. 31, 2012 a cafeteria plan may not allow an employee to request salary reduction contributions for a health FSA in excess of $2,500.

A cafeteria plan generally cannot provide for deferred compensation, permit participants to carry over unused benefits or contributions from one plan year to another, or permit participants to purchase a benefit that will be provided in a subsequent plan year. A cafeteria plan, however, may permit a participant in a profit sharing, stock bonus, or rural cooperative plan that has a qualified cash or deferred arrangement to elect to have the employer contribute on the employee's behalf to the plan. After-tax employee contributions to a qualified plan subject to IRC Section 401(m) are permissible under a cafeteria plan, even if matching contributions are made by the employer.

A FSA may allow a grace period of no more than 2½ months following the end of the plan year for participants to incur and submit expenses for reimbursement.

A cafeteria plan also may permit a participant to elect to have the employer contribute to a health savings account (HSA) on the participant's behalf. Unused balances in HSAs funded through a cafeteria plan may be carried over from one plan year to another.

Under the general rule, life, health, disability, or long-term care insurance with an investment feature, such as whole life insurance, or an arrangement that reimburses premium payments for other accident or health coverage extending beyond the end of the plan year cannot be purchased. Supplemental health insurance policies that provide coverage for cancer and other specific diseases do not result in the deferral of compensation and are properly considered accident and health benefits under IRC Section 106.

A cafeteria plan maintained by an educational organization described in IRC Section 170(b)(1)(A)(ii) (i.e., one with a regular curriculum and an on-site faculty and student body) can allow participants to elect postretirement term life insurance coverage. The postretirement life insurance coverage must be fully paid up on retirement and must not have a cash surrender value at any time. Postretirement life insurance coverage meeting these conditions will be treated as group term life insurance under IRC Section 79.

To provide tax favored benefits to highly compensated employees and "key employees," a cafeteria plan must meet certain nondiscrimination requirements and avoid concentration of benefits in key employees.

The Affordable Care Act requires plans and issuers that offer dependent coverage to make the coverage available until a child reaches the age of 26. To implement the expanded coverage, the ACA allows employers with cafeteria plans to permit employees to immediately make pre-tax salary reduction contributions to provide coverage for children under age 27, even if the cafeteria plan has not yet been amended to cover these individuals.

Both married and unmarried children qualify for this coverage. This rule applies to all plans in the individual market and to new employer plans. It also applies to existing employer plans unless the adult child has another offer of employer-based coverage. Beginning in 2014, children up to age 26 can stay on their parent's employer plan even if they have another offer of coverage through an employer.

Employees are eligible for the new tax benefit from March 30, 2010 forward, if the children are already covered under the employer's plan or are added to the employer's plan at any time. For this purpose, a child includes a son, daughter, stepchild, adopted child, or eligible foster child. This "up to age 26" standard replaces the lower age limits that applied under prior tax law, as well as the requirement that a child generally qualify as a dependent for tax purposes.

2. What are the income tax benefits of a cafeteria plan?

As a general rule, a participant in a cafeteria plan is not treated as being in constructive receipt of taxable income solely because he has the opportunity – before a cash benefit becomes available – to elect among cash and "qualified" benefits.

In order to avoid taxation, a participant must elect the qualified benefits before the cash benefit becomes currently available. That is, the election must be made before the specified period for which the benefit will be provided begins — generally, the plan year.

A cafeteria plan may, but is not required to, provide default elections for one or more qualified benefits for new employees or for current employees who fail to timely elect between permitted taxable and qualified benefits.

Note that a benefit provided under a cafeteria plan through employer contributions to a health flexible spending arrangement (FSA) is not treated as a qualified benefit unless the plan provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of $2,500 made to the FSA. For any taxable year beginning after December 31, 2013, the $2,500 limit will be increased for changes in the cost-of-living.

Under IRS Notice 2012-40:

(1) the $2,500 limit does not apply for plan years that begin before 2013;

(2) the term "taxable year" in IRC Section 125(i) refers to the plan year of the cafeteria plan, as this is the period for which salary reduction elections are made;

(3) plans may adopt the required amendments to reflect the $2,500 limit at any time through the end of calendar year 2014;

(4) in the case of a plan providing a grace period (which may be up to two months and 15 days), unused salary reduction contributions to the health FSA for plan years beginning in 2012 or later that are carried over into the grace period for that plan year will not count against the $2,500 limit for the subsequent plan year; and

(5) unless a plan's benefits are under examination by the IRS, relief is provided for certain salary reduction contributions exceeding the $2,500 limit that are due to a reasonable mistake and not willful neglect, and that are corrected by the employer.

3. What nondiscrimination requirements apply to cafeteria plans?

If a cafeteria plan discriminates in favor of highly compensated individuals as to eligibility to participate or discriminates in favor of highly compensated participants as to contributions or benefits, highly compensated participants will be considered in constructive receipt of the available cash benefit. "Highly compensated" individuals are officers, shareholders owning more than 5 percent of the voting power or value of all classes of stock, those who are "highly compensated," and any of their spouses or dependents. For this purpose, "highly compensated" means any individual or participant who, for the preceding plan year (or the current plan year in the case of the first year of employment), had compensation from the employer in excess of the compensation amount specified in IRC Section 414(q)(1)(B) ($115,000 for 2012 and 2013, up from $110,000 for 2009 through 2011), and, if elected by the employer, also was in the top-paid group of employees (determined by reference to Section 414(q)(3)) for such preceding plan year (or for the current plan year in the case of the first year of employment).

Participation will be nondiscriminatory if (1) it benefits a classification of employees found by the Secretary of Treasury not to discriminate in favor of employees who are officers, shareholders, or highly compensated, (2) no more than three years of employment are required for participation and the employment requirement for each employee is the same, and (3) eligible employees begin participation by the first day of the first plan year after the employment requirement is satisfied.

According to proposed regulations, a cafeteria plan does not discriminate in favor of highly compensated individuals if the plan benefits a group of employees who qualify under a reasonable classification established by the employer and the group of employees included in the classification satisfies the safe harbor percentage test or the unsafe harbor percentage test. These are the same nondiscriminatory classification tests used for qualified plans.

If a cafeteria plan offers health benefits, the plan is not discriminatory as to contributions and benefits if (1) contributions for each participant include an amount that either (x) equals 100 percent of the cost of the health benefit coverage under the plan of the majority of the highly compensated participants who are similarly situated (e.g., same family size); or (y) equals or exceeds 75 percent of the cost of the most expensive health benefit coverage elected by any similarly-situated participant; and (2) contributions or benefits in excess of (1) above bear a uniform relationship to compensation.

A plan is considered to satisfy all discrimination tests if it is maintained under a collective bargaining agreement between employee representatives and one or more employers.

In addition, a "key employee," as defined for purposes of the top-heavy rules will be considered in constructive receipt of the available cash benefit option in any plan year in which nontaxable benefits provided under the plan to key employees exceed 25 percent of the aggregate of such benefits provided to all employees under the plan. For this purpose, excess group term life insurance coverage that is includable in income is not considered a nontaxable benefit.

Employees of a controlled group of corporations, employers under common control, or members of an "affiliated service group" are treated as employed by a single employer.

Amounts that the employer contributes to a cafeteria plan pursuant to a salary reduction agreement will be treated as employer contributions to the extent that the agreement relates to compensation that has not been actually or constructively received by the employee as of the date of the agreement and subsequently does not become currently available to the employee.

4. What are the rules that apply to simple cafeteria plans for small businesses?

A "simple cafeteria plan" means a cafeteria plan that is established and maintained by an eligible employer and with respect to which contribution, eligibility, and participation requirements are met.

For years beginning after December 31, 2010 the Patient Protection and Affordable Care Act of 2010 ("PPACA") provides a safe harbor "simple cafeteria plan" under which an "eligible employer" (generally an employer with fewer than 100 employees) is treated as meeting any applicable nondiscrimination requirements for the year.

The employer is required to make contributions on behalf of each "qualified employee" in an amount equal to the following: (1) a uniform percentage (not less than 2 percent) of the employee's compensation; or (2) an amount not less than the lesser of (x) 6 percent of the employee's compensation for the plan year, or (y) twice the amount of salary deduction contributions of each qualified employee. Contribution requirement option (2) is not met if the rate of contributions with respect to the salary contributions of any highly compensated or key employee at any rate of contribution is greater than that with respect to an employee who is not a highly compensated or key employee.

All employees with at least 1,000 hours of service during the preceding plan year must be eligible to participate. Each employee who is eligible to participate must be able to select any benefit available under the plan. An employee can be excluded if the employee:

(1) is under age 21;

(2) has less than one year of service;

(3) is covered by a collective bargaining agreement and the benefits of a cafeteria plan were the subject of good faith bargaining; or

(4) is a nonresident alien working outside of the United States.

"Eligible employer" means, with respect to any year, any employer that employed an average of 100 or fewer employees on business days during either of the two preceding years. An employer that initially qualifies for a simple cafeteria plan ceases to qualify in the year after the number of employees reaches 200.

5. When can benefit elections under a cafeteria plan be changed?

There are only certain instances when a cafeteria plan may permit an employee to revoke an election during a period of coverage and to make a new election relating to a qualified benefits plan.

A cafeteria plan may permit an employee to revoke an election for coverage under a group health plan during a period of coverage and make a new election that corresponds with the special enrollment rights of IRC Section 9801 (f). (This section deals generally with special enrollment periods for persons losing other group health plan coverage and dependent beneficiaries.) An election change with respect to the Section 9801(f) enrollment rights can be funded through salary reduction under a cafeteria plan only on a prospective basis, except for the retroactive enrollment right under Section 9801(f) that applies in the case of elections made within 30 days of a birth, adoption, or placement for adoption.

Certain changes are permitted with respect to a judgment, decree, or order resulting from a divorce, legal separation, annulment, or change in legal custody (including a qualified medical child support order) that requires accident or health coverage for an employee's child or for a foster child who is a dependent of the employee. A cafeteria plan may change the employee's election to provide coverage for the child if an order requires coverage for the child under the employer's plan. Also, the plan may permit the employee to make an election change to cancel coverage for the child if an order requires the spouse, former spouse, or other individual to provide coverage for the child and that coverage actually is provided.

Additionally, if an employee, spouse, or dependent who is enrolled in the employer's accident or health plan becomes entitled to coverage (i.e., becomes enrolled) under Medicaid or Part A or Part B of Medicare, the plan may permit the employee to make a prospective election change to reduce or cancel coverage of that employee, spouse, or dependent under the accident or health plan. Note that this does not apply to coverage consisting solely of benefits under the Social Security Act Section 1928 program for distribution of pediatric vaccines.

If an employee, spouse, or dependent that has been entitled to Medicaid or Medicare Part A or Part B coverage loses eligibility for the coverage, the plan may allow the employee to make a prospective election to commence or increase coverage of that employee, spouse, or dependent under the accident or health plan.

An employee taking a leave under the Family and Medical Leave Act ("FMLA") may revoke an existing election of accident or health plan coverage and make such election as provided for under the FMLA for the remaining portion of the period of coverage.

Regarding contributions under a qualified cash or deferred arrangement, the regulations state that these provisions do not apply to elective contributions under such an arrangement, within the meaning of IRC Section 401(k), or employee contributions subject to IRC Section 401(m). Therefore, a cafeteria plan may allow an employee to modify or revoke elections as provided by these sections and applicable regulations.

If a cafeteria plan offers salary reduction contributions to health savings accounts ("HSAs"), the plan must allow participants to prospectively change or revoke salary reduction elections for HSA contributions on a monthly, or more frequent, basis.

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