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Office Hours Webinar

Section 125 Cafeteria Plans

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Today's Topics

The Gateway to Employee Pre-Tax Contributions

A Simple Concept Wrapped in a Complex Rule

- Employees generally take for granted the fact that they can contribute to H&W benefits on a pre-tax basis through payroll
- This ability is actually the product of a tangled web of cafeteria plan rules that permit employees to avoid constructive receipt—a concept most have never considered
- The election rules in Section 125 are very strict, and there is no correction program to prevent a potential full loss of tax-advantaged status for an employer's failure to follow
- This makes understanding and complying with the Section 125 rules more important than most appreciate—and it puts the cafeteria plan at the forefront of many common compliance issues

Section 125 Cafeteria Plan Guide Topics

1. **Why §125 matters:** The safe harbor from the doctrine of constructive receipt
2. **Plan document:** Employers must adopt a written plan document with certain content included
3. **Making/changing elections:** Irrevocable election rule and permitted election change events
4. **Use-It-Or-Lose-It:** Grace periods, run-out periods, carryovers, and forfeitures—oh my! Plus, new $7,500 DCFSA limit for 2026
5. **Nondiscrimination:** The basics for each NDT, diving into the weeds of the 55% average benefits test

01

Why Does §125 Matter?

The Safe Harbor from Constructive Receipt

Why Section 125 Matters: Safe Harbor from Constructive Receipt

Section 125 is the **exclusive means** by which an employer can offer employees an election between taxable income and nontaxable benefits on a tax-advantaged basis.

Without a Cafeteria Plan: Constructive Receipt (Taxable)	**Cafeteria Plan:** Pre-Tax Contributions
General Rule: • Employees must include in income any amount which they actually or constructively receive • Means that the election between taxable income (including cash) and nontaxable benefits results in gross income to the employee—even the employees who elect benefits! **Cites:** • IRC §451; Treas. Reg. §1.451-1(a)	**General Rule:** • Section 125 cafeteria plans avoid constructive receipt issues • Allows employees to make a choice between taxable cash income and nontaxable benefits • Means employees electing to make a salary reduction election to pay for health and welfare benefits on a pre-tax basis will not receive taxable income on the taxable cash the employees could have received **Cites:** • IRC §125; Prop. Treas. Reg. §1.125-1(b)(1)

Why Section 125 Matters: Safe Harbor from Constructive Receipt

Examples:

Without a Cafeteria Plan: Constructive Receipt (Taxable)	**Cafeteria Plan:** Pre-Tax Contributions
• The ABC group health plan premium is $500/month • The employer pays $350/month • The employee-share of the premium is $150/month **Result:** Employees who enroll with a salary reduction election of $150/month are still taxed on the $150 in taxable cash they could have received.	Same example, but with Section 125 cafeteria plan in place. **Result:** • Employees who enroll with a salary reduction election of $150/month contribute on a pre-tax basis • No constructive receipt of the $150 available as taxable cash • Employer and employee avoid FICA taxes (6.2% Social Security, 1.45% Medicare) on the contributions, too!

Who Can Offer A Section 125 Cafeteria Plan? Who Can Participate in the Plan?

Employers Sponsor:

Any Employer Can Establish a Cafeteria Plan

- Must have employees on the U.S. payroll
- No size restrictions
- Includes all forms of corporate structures

Employees Participate:

All Common Law Employees Can Participate

- Must be on the U.S. payroll with U.S. source income
- Cafeteria plan terms set specific eligibility conditions, typically tied to eligibility for the health plan
- Dependents cannot participate because the cafeteria plan is simply the vehicle for the employee to pay on a pre-tax basis for underlying benefits (which may cover dependents)
- Self-employed individuals cannot participate in the cafeteria plan but can participate in underlying non-FSA benefits where eligible

Exclusion: More-Than-2% Shareholders in S Corporation

- Treated as self-employed and ineligible to participate in cafeteria plan
  - May still be eligilble for underlying benefits (e.g., medical, dental, vision), but must pay after-tax
  - Generally can take deduction on individual tax return

Exclusion: Members of an LLC

- Treated as self-employed and ineligible to participate in cafeteria plan
  - May still be eligible for underlying benefits (e.g., medical, dental, vision), but must pay after-tax
  - Generally can take deduction on individual tax return

Exclusion: Partners in a Partnership

- Treated as self-employed and ineligible to participate in cafeteria plan
  - May still be eligible for underlying benefits (e.g., medical, dental, vision), but must pay after-tax
  - Generally can take deduction on individual tax return

Section 125 Cafeteria Plan: Qualified Benefits

Section 125 permits employees to choose between taxable cash and “qualified benefits” through a cafeteria plan. Only **qualified benefits** can be part of a cafeteria plan.

Qualifed Benefits: Employee Pre-Tax Contributions	**Non-Qualified Benefits:** Not Part of Cafeteria Plan
• Group Health Plan (Medical, Dental, Vision) • Health FSA, Dependent Care FSA • HSA • Group Term Life ($50k coverage cap) • AD&D • Hospital Indemnity/Cancer Insurance • Disability (generally contributions or benefits are taxable) • 401(k) Plan (cashable flex credits, uncommon) • Adoption Assistance (no FICA exemption, uncommon) • PTO Buying/Selling (uncommon)	• Commuter Transit/Vanpool/Parking (§132 provides for employee pre-tax contributions) • HRA (no employee contributions permitted) • Tuition Assistance (employer tax-free reimbursement permitted under §127 or §132) • 403(b) Plan (different from 401(k)!) • Long-Term Care Insurance • Individual Medical Policies (prohibited by ACA, only permitted if purchased off Exchange for EEs covered by an ICHRA)

02

Plan Document

Timing and Content Rules

Cafeteria Plan Document: Prospective Adoption/Amendment

Retroactive Adoption Prohibited

- The Section 125 cafeteria plan needs to be signed (adopted) on or before the first day of the plan year that it will be effective
- If an employer implements a cafeteria plan with an effective date prior to the date the document is signed (i.e., with a retroactive effective date) the IRS could find that the document is not a valid cafeteria plan
- That would result in all employee health and welfare premium and FSA pre-tax elections becoming taxable to the employees
  - *American Family Mutual Insurance Co. v. United States, 815 F. Supp. 1206, 1214 (W.D. Wis. 1992)*
    - Employees participated in health FSA before cafeteria plan was adopted
    - Court found contributions must be included in employees' taxable income
    - Employer's tax liability from the error was $433,000
  - *Wollenburg v. United States, 75 F. Supp. 2d 1032, 1036 (D. Neb. 1999)*
    - Court relied on American Family to assess taxes on health FSA contributions made prior to plan being adopted in December of plan's calendar plan year (similar result)

Prospective Amendment or Restatement Adoption

- Any subsequent amendment to or restatement of the plan document must be prospective
  - Section 125 cafeteria plan amendment or restatement cannot have retroactive effect
  - Employer must sign the amendment or restatement on or before the date for which it is to be effective
- Retroactive effective dates do not receive Section 125 safe harbor from constructive receipt
  - This could result in the employee H&W premium and FSA pre-tax elections becoming taxable

Cafeteria Plan Document: Required Content

Written Plan Requirements – Prop. Treas. Reg §1.125-1(c)(1)

The Section 125 regulations provide that the written plan document must include:

- A specific description of each of the benefits available through the plan, including the periods during which the benefits are provided (the periods of coverage)
- The plan's rules governing participation, and specifically requiring that all participants in the plan be employees
- The procedures governing employees' elections under the plan, including the period when elections may be made, the periods with respect to which elections are effective, and providing that elections are irrevocable (outside of the permitted election change events recognized in the Section 125 regulations and incorporated into the plan)
- The manner in which employer contributions may be made under the plan (employee salary reduction election, employer nonelective contributions, flex credits, etc.)
- The maximum amount of elective contributions (i.e., salary reduction) available to any employee through the plan (e.g., $3,300 health FSA in 2025, $5,000 dependent care FSA)
- The plan year of the cafeteria plan
- The special rules that apply to FSAs (e.g., use-it-or-lose-it rule, uniform coverage for health FSA)
- A description of the plan's grace period or carryover period (if offered)
- If the plan offers PTO buying/selling (uncommon), special ordering rules that apply

03

Making/Changing Elections

The Irrevocable Election Rule

Making/Changing Elections: The Section 125 Irrevocable Election Requirement

The general rule under Section 125 for ongoing employees is that all elections (including an election not to participate) must be:

1. Made prior to the start of the plan year; **and**
2. Irrevocable for the duration of the plan year, unless the employee experiences a permitted election change event.

The Section 125 Irrevocable Election Rule

Potential Consequences for Failure to Follow these Rules

If an employer's cafeteria plan were to permit employees to make any mid-year (i.e., after the start of the plan year) election changes without experiencing a permitted election change event (or without making the election change within the plan's timing window, which is generally 30 days):

- The plan would violate the irrevocable election rules described above
- **The Section 125 rules provide that the IRS could cause the entire cafeteria plan to lose its tax-advantaged status if discovered on audit**
- **This would result in all elections becoming taxable for all employees**

No Correction Program

There is no formal IRS correction program for employers to address Section 125 violations!

- The tax qualification rules for qualified retirement plans, which include correction procedures through the Employee Plans Compliance Resolution System (EPCRS), do not apply to cafeteria plans
- Upon audit, the IRS has discretion to impose full loss of tax-advantaged status in any non-compliance scenario—no matter how seemingly minor or commonplace

Prop. Treas. Reg. §1.125-1(c)(7)

Relevant Cite: Irrevocable Election Noncompliance Consequences

(7) Operational failure.

i. In general. **If the cafeteria plan fails to operate according to its written plan or otherwise fails to operate in compliance with section 125 and the regulations, the plan is not a cafeteria plan and employees' elections between taxable and nontaxable benefits result in gross income to the employees.**

ii. Failure to operate according to written cafeteria plan or section 125. Examples of failures resulting in section 125 not applying to a plan include the following—

A. Paying or reimbursing expenses for qualified benefits incurred before the later of the adoption date or effective date of the cafeteria plan, before the beginning of a period of coverage or before the later of the date of adoption or effective date of a plan amendment adding a new benefit;

B. Offering benefits other than permitted taxable benefits and qualified benefits;

C. Operating to defer compensation (except as permitted in paragraph (o) of this section);

D. Failing to comply with the uniform coverage rule in paragraph (d) in §1.125-5;

E. Failing to comply with the use-or-lose rule in paragraph (c) in §1.125-5;

F. Allowing employees to revoke elections or make new elections, except as provided in §1.125-4 and paragraph (a) in §1.125-2;

G. Failing to comply with the substantiation requirements of § 1.125-6;

H. Paying or reimbursing expenses in an FSA other than expenses expressly permitted in paragraph (h) in §1.125-5;

I. Allocating experience gains other than as expressly permitted in paragraph (o) in §1.125-5;

J. Failing to comply with the grace period rules in paragraph (e) of this section; or

K. Failing to comply with the qualified HSA distribution rules in paragraph (n) in §1.125-5.

Prop. Treas. Reg. §1.125-2(a)

Relevant Cite Cont'd: Irrevocable Election Noncompliance Consequences

(a) Rules relating to making and revoking elections.

1. Elections in general. A plan is not a cafeteria plan unless the plan provides in writing that employees are permitted to make elections among the permitted taxable benefits and qualified benefits offered through the plan for the plan year (and grace period, if applicable). **All elections must be irrevocable by the date described in paragraph (a)(2) of this section except as provided in paragraph (a)(4) of this section.** An election is not irrevocable if, after the earlier of the dates specified in paragraph (a)(2) of this section, employees have the right to revoke their elections of qualified benefits and instead receive the taxable benefits for such period, without regard to whether the employees actually revoke their elections.
2. Timing of elections. In order for employees to exclude qualified benefits from employees' gross income, benefit **elections in a cafeteria plan must be made before the earlier of—**
   i. The date when taxable benefits are currently available; or
   ii. The first day of the plan year (or other coverage period).
3. Exceptions to rule on making and revoking elections. If a cafeteria plan incorporates the change in status rules in §1.125-4, to the extent provided in those rules, **an employee who experiences a change in status (as defined in §1.125-4) is permitted to revoke an existing election and to make a new election with respect to the remaining portion of the period of coverage, but only with respect to cash or other taxable benefits that are not yet currently available.** See paragraph (c)(1) of this section for a special rule for changing elections prospectively for HSA contributions and paragraph (r)(4) in §1.125-1 for section 401(k) elections. Also, only an employee of the employer sponsoring a cafeteria plan is allowed to make, revoke or change elections in the employer's cafeteria plan. The employee's spouse, dependent or any other individual other than the employee may not make, revoke or change elections under the plan.

Making/Changing Elections – Open Enrollment

No Mandatory Open Enrollment (OE) Timeframe

- The Section 125 rules do not specify any period during which an employer is required to offer its open enrollment for the next plan year (nor does ERISA or any other applicable law)
- The only requirement under Section 125 is that **the election be made prior to the start of the plan year** (any other election change would be mid-year and require one of the listed events)

What About Post-Open Enrollment Election Change Requests?

- The OE period is established for the employer's convenience and administrative reasons
- There is no legal issue with allowing employees to make elections all the way up to the last second before the start of the new plan year
- **Employers may therefore permit exceptions to allow election changes after OE ends (<u>but before the plan year begins</u>) as long as they are comfortable with the precedent established**
- Employers often want to permit employees to change elections after the employer's OE closes because of the employee's changed decision or alleged mistake
- This creates an **ERISA plan precedent** requiring the employer to provide the same opportunity to other employees in a similar situation who request a post-OE but pre-plan year election change
  - The main reason for employers structuring OE as a set period to end in advance of the plan year is for administrative purposes
  - If employees were able to make election changes all the way up to the last day of the current plan year (12/31 for a calendar plan year) it would be very difficult to implement their elections prior to the next period of coverage (plan year)

Making/Changing Elections – Open Enrollment

How to Address Post-Open Enrollment (But Pre-Plan Year) Election Change Requests

Post-Open Enrollment Best Practice Approaches	What Happens When the Plan Year Starts?
Employers have two best practice options for handling post-OE election change requests: 1. Enforce the end of the OE as a hard deadline after which no employees may change their elections; OR 2. Permit post-OE election changes with a hard outer limit prior to the start of the plan year after which the employer will not accept any other post-OE election changes—regardless of the circumstances. • Example: Hard outer limit of two weeks in advance of the plan year (12/15 for a calendar plan year) • This ensures that the precedent established is managed in a manner that permits all elections for the new plan year (1/1 for a calendar plan year) to be timely implemented	• Generally there is no ability to change an employee's election because the election is irrevocable under Section 125 as of the start of the plan year • Even if an employer were to assume the risk under Section 125, it would still have insurance carrier (or stop-loss provider) limitations and an ERISA plan precedent to address • In some rare circumstances, the IRS informal "doctrine of mistake" may apply to permit a late election change after the plan year has started • This requires "clear and convincing evidence" of a mistaken election, which is a very high bar to clear • Later slides address mid-year exceptions and the doctrine of mistake in more detail

Making/Changing Elections – Open Enrollment

Two Health Plan Election Options at Open Enrollment for Ongoing Employees

1. Affirmative Elections; or
2. Passive Enrollment (Rolling Elections)

Affirmative Elections

- The standard approach where the employee must opt-in to coverage by electing to enroll in the health plan and pay the associated employee-share of the premium on a pre-tax basis through the Section 125 cafeteria plan
  - Under this approach, employees who take no action will not be enrolled

Passive Enrollment (Rolling Elections)

- Employees' existing plan elections for the current plan year—including to pay the associated employee-share of the premium pre-tax through the cafeteria plan—automatically roll to the next plan year if the employee takes no action
  - Employees wishing to change their election (including to waive or change options) must do so affirmatively at open enrollment
- Employers utilizing a passive enrollment structure should clearly communicate the rolling election feature at OE, including:

Description of the rolling election process	Employee-share of the premium for each plan option	Procedures for declining (waiving) coverage
OE deadline to make a different election	Statement that affirmative or rolling election is irrevocable	List of the employee's current plan year elections

Making/Changing Elections – New Hires

General Rule: Prospective Election

- The general rule under Section 125 for mid-year election changes, including for new hires, is that any election change must be prospective in effect
- This means that the employee's pre-tax contribution cannot relate to coverage in effect prior to the date of the election

Special New Hire Rule: Retroactive Elections 30 Days from Date of Hire (DOH)

The Section 125 rules provide that an election may be retroactive to the date of hire as long as it is made within 30 days of the date of hire.

- **Example:** New employee hired March 21 to ABC employer with DOH eligibility for coverage
- **Result:** If employee makes election by April 20, employee can pay for the coverage pre-tax through the cafeteria plan retroactive to March 21 (DOH)

Plans That Don't Offer DOH Eligibility with 30-day Election Window

- There is no option for new hires to pay for the period of coverage prior to the date of the election (e.g., 60-day election window, eligibility is one-month after hire, etc.)
- Options for employers in these situations:
  - The employer would have to pay the full cost of the retroactive period (i.e., waive the employee-share of the premium for the period prior to the date of the election);
  - The employer would require the employee pay for the retroactive coverage period on an after-tax basis (i.e., the employee pays outside of the cafeteria plan for the period prior to the election); OR
  - Coverage would be effective no sooner than the date the employee elects to enroll (i.e., no retroactive coverage prior to the date of the election)

Making/Changing Elections – New Hires

Two Health Plan Election Options for Newly Eligible Employees

1. Affirmative Elections; or
2. Automatic Enrollment (Default Elections)

Affirmative Elections

- The standard approach where the employee must opt-in to coverage by electing to enroll in the health plan and pay the associated employee-share of the premium on a pre-tax basis through the Section 125 cafeteria plan
  - Under this approach, employees who take no action will not be enrolled

Automatic Enrollment (Default Elections)

- Automatic enrollment treats an employee's failure to act as a default election to enroll in the health plan and pay the associated employee-share of the premium on a pre-tax basis through the Section 125 cafeteria plan
  - Generally would utilize the lowest-cost, employee-only coverage as the plan option subject to automatic enrollment
- Employers utilizing an automatic enrollment approach must provide employees with a notice explaining the process, including:

The employee-share of the premium	Procedures for declining coverage	The OE deadline to make a different election
Statement that the election is irrevocable for plan year	The right to decline coverage (and avoid the cost)	The plan options subject to automatic enrollment

Making/Changing Elections – Mid-Year Events

Permitted Election Change Event Required

- The general rule under Section 125 for ongoing employees is that all elections (including an election not to participate) must be:
  1. Made prior to the start of the plan year; and
  2. Irrevocable for the duration of the plan year **unless the employee experiences a permitted election change event.**
- Employers do not have to include all permitted election change events in the cafeteria plan, but generally all do (subject to any limitations imposed by the insurance carrier or stop-loss provider)
- Most cafeteria plans provide that employees have 30 days to make an election change from the date of the permitted election change event

Change in Status Events

- This is the broadest section of permitted election change events in the Section 125 regulations that come up the most often
- Generally requires that the election change be on account of and correspond with the event
  - Commonly referred to as the “consistency rule”

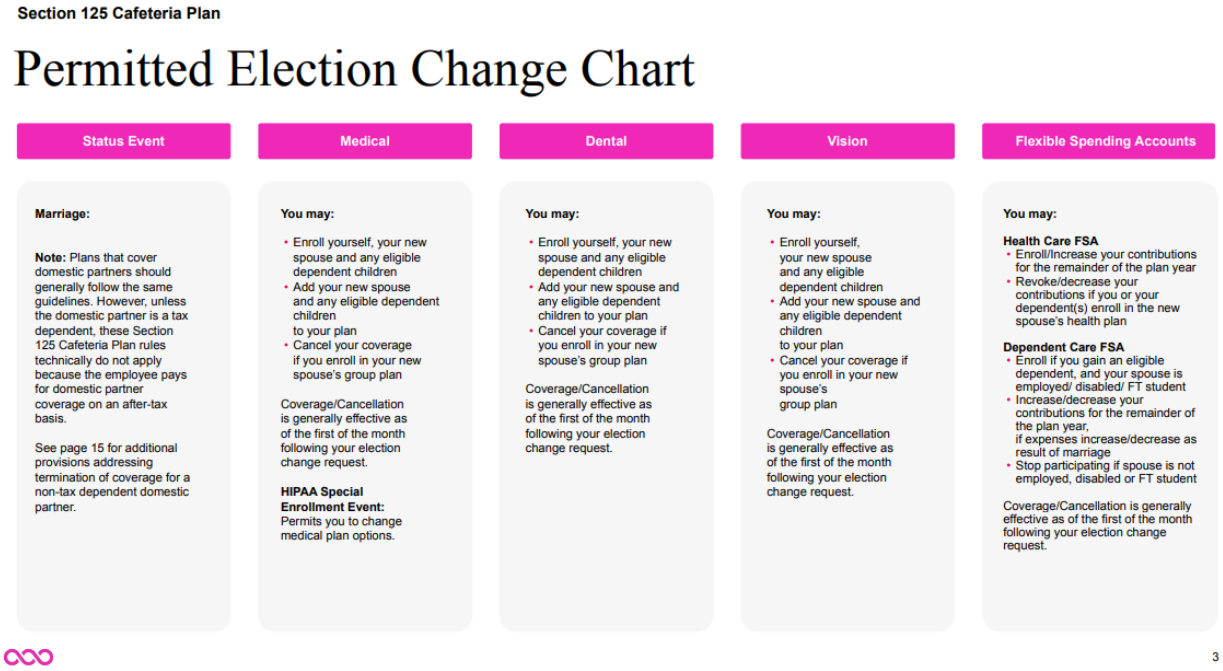
Other Permitted Election Change Events

- HIPAA special enrollment events, cost changes, plan changes, ACA exchange events, COBRA qualifying events, QMCSO/NMSN, Medicare/CHIP events, FMLA events
  - There are a lot of potential permitted election change events out there, many with special rules!

Mid-Year Election Changes

Newfront Section 125 cafeteria plan permitted election change event chart

Click here for a summary overview of the permitted election change events!



Section 125 Cafeteria Plan

Permitted Election Change Chart

Status Event	Medical	Dental	Vision	Flexible Spending Accounts
Marriage: **Note:** Plans that cover domestic partners should generally follow the same guidelines. However, unless the domestic partner is a tax dependent, these Section 125 Cafeteria Plan rules technically do not apply because the employee pays for domestic partner coverage on an after-tax basis. See page 15 for additional provisions addressing termination of coverage for a non-tax dependent domestic partner.	**You may:** • Enroll yourself, your new spouse and any eligible dependent children • Add your new spouse and any eligible dependent children to your plan • Cancel your coverage if you enroll in your new spouse's group plan Coverage/Cancellation is generally effective as of the first of the month following your election change request. **HIPAA Special Enrollment Event:** Permits you to change medical plan options.	**You may:** • Enroll yourself, your new spouse and any eligible dependent children • Add your new spouse and any eligible dependent children to your plan • Cancel your coverage if you enroll in your new spouse's group plan Coverage/Cancellation is generally effective as of the first of the month following your election change request.	**You may:** • Enroll yourself, your new spouse and any eligible dependent children • Add your new spouse and any eligible dependent children to your plan • Cancel your coverage if you enroll in your new spouse's group plan Coverage/Cancellation is generally effective as of the first of the month following your election change request.	**You may:** **Health Care FSA** • Enroll/Increase your contributions for the remainder of the plan year • Revoke/decrease your contributions if you or your dependent(s) enroll in the new spouse's health plan **Dependent Care FSA** • Enroll if you gain an eligible dependent, and your spouse is employed/ disabled/ FT student • Increase/decrease your contributions for the remainder of the plan year, if expenses increase/decrease as result of marriage • Stop participating if spouse is not employed, disabled or FT student Coverage/Cancellation is generally effective as of the first of the month following your election change request.

3

Changing Elections: HIPAA Special Enrollment Events

Which Events Qualify?

The following events qualify as HIPAA special enrollment events:

- Loss of eligibility for other group health coverage or individual insurance coverage
- Loss of Medicaid/CHIP eligibility or becoming eligible for a state premium assistance subsidy under Medicaid/CHIP
- Acquisition of a new spouse or dependent by marriage, birth, adoption, or placement for adoption

The medical plan **must** permit employees to make election changes as required by HIPAA

- Other Section 125 permitted election change events are optional for employer and carrier/stop-loss to recognize
- The medical plan and insurance carrier/stop-loss must accommodate all HIPAA special enrollment events

Right to Change Medical Plan Options

- Upon experiencing a HIPAA special enrollment event, the plan is **required** to allow the employee to select any medical benefit package under the plan
  - For example, move from Kaiser to UHC, Cigna to Kaiser, HMO Low to PPO High, etc.

General 30-Day Election Period

- Employees must have a period of at least **30 days** from the date of the event to enroll or change their election pursuant to a HIPAA special enrollment event
  - Longer periods would need to be approved by the insurance carrier or stop-loss provider

Medicaid/CHIP: Special 60-Day Election Period

- When employees lose Medicaid/CHIP eligibility, or where they gain eligibility for a state premium assistance subsidy under Medicaid/CHIP, they must have at least **60 days** from the date of the event to enroll or change their election
  - This is a good ERISA trivial pursuit question

Changing Elections: HIPAA Special Enrollment Events

Effective Date: Generally First of the Month Following Election

- The general rule is that an election to enroll in coverage pursuant to a HIPAA special enrollment event must be effective **no later than the first of the month following the date of the timely submitted election change request**
  - **Example 1:** Jack marries Jill on April 19, and he submits the election change request to enroll Jill on April 22. Jill's coverage should be effective no later than May 1.
  - **Example 2:** Jack marries Jill on April 19, but does not submit the election change request to enroll Jill until May 14. Jill's coverage should be effective no later than June 1.

Birth/Adoption: Coverage Retroactive to the Date of the Event

- Where an employee has a new child through birth, adoption, or placement for adoption, coverage for the new child **must be effective as of the date of the event**
- In other words, coverage is effective the date of the birth, adoption, or placement for adoption
  - **Example:** Jack's spouse Jill gives birth to a child on July 19. Jack submits the election change to enroll the child on August 14. The child's coverage must be effective as of July 19 (the date of birth)

Existing Dependents: No Special Enrollment Rights

- Upon birth, HIPAA rules limit the special enrollment rights to the employee, the spouse, and any newly acquired dependents (i.e., the newborn child)
- Any other dependents (e.g., siblings of the newborn child) are not entitled to special enrollment rights upon the employee's acquisition of the new dependent through birth
  - The exclusion of existing dependents from special enrollment rights prevents the employee from having the right to add an existing child to the plan upon the birth of the new child (optional cafeteria plan "tag-along" rule may permit enrollment)

Changing Elections: Substantiation of Events

No Requirement for Employee to Provide Supporting Documentation

- The Section 125 rules **do not require any specific substantiation procedures** for an employer to confirm that an employee has experienced a permitted election change event
  - Almost always fine for the employer to rely solely on the employee's certification that the event has occurred—without any form of documentation beyond the employee's certification to support the event

Exception: Employer Suspects Fraud

- The only time the Section 125 rules specifically require supporting documents (beyond the employee's certification) to substantiate the event is **where the employer has reason to believe that the employee's certification is fraudulent or otherwise incorrect**
  - In those circumstances, the employer must request documentation to substantiate the event before implementing the requested election change

Best Practice: Be Consistent and Keep Records

Regardless of which approach the employer takes, it should:

a. Apply the approach consistently (i.e., require supporting documents or not consistently); and
b. Keep a record of the employee's certification of the event (e.g., the ben admin system's record of the employee verification of the event) for all election changes

Relevant Cite

66 Fed. Reg. 1837, 1838 (Jan. 10, 2001)

https://www.federalregister.gov/documents/2001/01/10/01-258/tax-treatment-of-cafeteria-plans

- "An example in the final regulations has been revised to make it clear that employers may generally rely on an employee's certification that the employee has or will obtain coverage under the other plan (assuming that the employer has no reason to believe that the employee certification is incorrect)."

Changing Elections: Exception Requests

Employees Often Ask for Exceptions to Change Elections Mid-Year Outside of a Permitted Election Change Event

Three main reasons why we recommend **not** permitting employees to enroll themselves or a dependent mid-year without experiencing a permitted election change event (or after the plan's 30-day window to make the election change):

1. Section 125 Cafeteria Plan Rules
2. Insurance Carrier Policy (or Stop-Loss Provider) Limitations
3. ERISA Plan Precedent Concerns

Changing Elections: Exception Requests

Three Main Reasons Why Exceptions Are Not Recommended

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Reason #1: The Section 125 Cafeteria Plan Rules

Failure to adhere to the permitted election change event rules set forth in Treas. Reg. §1.125-4 can **cause the entire cafeteria plan to lose its tax-advantaged status**

- This would result in all elections becoming taxable to all employees
- Could permit employee to pay after-tax outside the cafeteria plan, but still issues #2 and #3

Changing Elections: Exception Requests

Three Main Reasons Why Exceptions Are Not Recommended

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Reason #2: Insurance Carrier Policy (or Stop-Loss Provider) Limitations

Insurance carriers (and stop-loss providers) generally will pay claims only for employees and dependents who are eligible and properly enrolled

- Carriers generally will permit employees to enroll only at open enrollment, upon new hire/newly eligible status, and within 30 days of experiencing a permitted election change event
- **If a carrier discovers that an employee was allowed to enroll in any other situation, the carrier would be within its right to deny paying all claims for that employee/dependent**
- **That would make the employer responsible for self-funding all claims (worst-case scenario!)**
- Crucial that carrier (or stop-loss provider for self-insured) agree to any exception for mid-year enrollment if employer makes exception

Changing Elections: Exception Requests

Three Main Reasons Why Exceptions Are Not Recommended

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Reason #3 ERISA Plan Precedent Concerns

- ERISA requires that employers administer the plan in accordance with the terms of the written plan document
  - Plan document will not permit employees to make election changes unless they experience a permitted election change event and make the election within the required timeframe (typically 30 days)
  - If the employer makes an exception, the employer has interpreted the plan's terms to permit the exception, and this interpretation must be applied consistently for all similarly situated employees
- **This means that exceptions create an ERISA plan precedent requiring the plan to permit election changes for all employees in similar circumstances**
  - Employees denied ability to change their election in similar circumstances would have a potential claim for ERISA breach of fiduciary duty or claim for benefits

Changing Elections: Exception Requests

Three Main Reasons Why Exceptions Are Not Recommended

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Summary

- For these three reasons, employers should generally avoid making mid-year enrollment exceptions outside of a permitted election change event
  - The issues associated with making an exception in most cases far outweigh the typical hardship case presented by the employee requesting the late enrollment
- There may be some very rare situations where employers consider making a mid-year enrollment exception despite the inherent plan risks
  - In these situations, employers will need to take employee contributions on an after-tax basis, ensure the insurance carrier (or stop-loss provider) approves the enrollment, and understand they must apply the exception consistently for similarly situated employees based on the applicable scope of the ERISA plan precedent

Changing Elections: Doctrine of Mistake (Rare)

IRS has provided informal guidance that an employee's election can be undone if there is **"clear and convincing evidence"** that a mistake has been made. This is a very high standard! Facts and circumstances must be completely persuasive to qualify—which rarely occurs. The strong presumption is always employees have just changed their mind.

Example 1: Dependent Care FSA No Qualifying Dependents	**Example 2:** Benefits Administration System Causes Incorrect Health Plan Election
Employee must have no dependents who can benefit from the FSA to be "clear and convincing" • Employee has no children, all of employee's children are age 13 or older with no disabilities, or the employee does not have a disabled spouse or dependent whose expenses would be eligible • Mistake as to the benefit's scope or tax treatment does not qualify • Corrected by refunding employee's contributions as taxable income subject to withholding and payroll taxes	**Employee attempted to complete election process, but the ben admin system failed to properly finalize** • Should be some forensic analysis of the enrollment system available to confirm that the employee actually partially completed the election process • Ideally would show elections that employee provisionally made • This would be a strong argument for clear and convincing evidence of a mistaken election (i.e., mistake failure to elect) • Carrier (or stop-loss) must still approve!

Changing Elections: Doctrine of Mistake (Rare)

Documenting Doctrine of Mistake: Employee Attestation to Confirm Facts and Circumstances

If the employer undoes the election based on the doctrine of mistake, the employer should:

- Clearly document for the employer's file the facts and circumstances providing the basis for the employer's finding of clear and convincing evidence of the mistaken election;
- Require the employee to sign-off on these facts; **and**
- Be clear in any communication that it is only very rare circumstances that an employer could modify an existing election mid-year (including an affirmative or default election not to participate) without experiencing a Section 125 permitted election change event

Employee Attestation Sample Language

I understand the general rule under Section 125 is that all cafeteria plan elections (including an election not to participate by failure to elect) must be:

- Made prior to the start of the plan year; and
- Irrevocable for the plan year unless I experience a permitted election change event set forth in Treas. Reg. §1.125-4.

The circumstances in this situation constitute a rare exception under the IRS "doctrine of mistake" approach because there is clear and convincing evidence of a mistaken election.

The Uniform Interval Rule

Employers Generally Must Take Contributions Ratably Over Plan Year

- The Section 125 rules require that the interval for taking FSA contributions be uniform for all participants (Prop. Treas. Reg. §1.125-5(g)(2))
- Means that the employer cannot have some employees making contributions at a different interval than other employees (e.g., some each pay period and some once per month)
  - The cafeteria plan is permitted to specify any interval for taking employee contributions
  - In almost all situations, the employer will take contributions on the uniform interval of each payroll period for all employees
  - Although these rules are in a section for FSAs, they are generally interpreted to apply to all cafeteria plan contributions, including the employee-share of the premium and HSAs

Common Request: Front-Load FSA/HSA Contributions (Not Permitted)

- Employers should generally refuse to accommodate these requests as not permitted
- Although it's not explicit in the rules that contributions must be taken ratably, it would not make sense to have a uniform interval requirement if employees could contribute different amounts at the set uniform interval
  - *Common Request #1: Dependent Care FSA*—Employee requests to front-load dependent care FSA contributions at the start of the year or prior to termination of employment
  - *Common Request #2: HSA*—Employees often think they can follow the same approach as with their 401(k) to front-load HSA contributions at the start of the year or prior to termination of employment (They can still front-load HSA contributions outside of payroll)

Example

Impermissible Front-Loading

- Employee elects to contribute $5,000 to the dependent care FSA
- Employer has 24 semi-monthly pay periods used as its contribution interval for all employees
- The per pay period contribution amount is $208.33 ($5,000/24)
- The contribution amount cannot be $300 one pay period, $200 the next, etc. (i.e., must be ratable)
- The contribution amount also cannot be increased upon request, such as to front-load all $5,000 on the first pay period(s) or just prior to termination of employment

Correcting Missed Contributions

Employers generally have three straightforward options to address missed Section 125 cafeteria plan contributions:

Option #1
Repay Over Multiple Pay Periods

Employers can choose to collect the correct missed contributions over some or all of the remaining pay periods of the plan year. Employers should notify employees of this approach in advance so they will be aware of the additional withholding from their payroll to address the retroactive contributions.

Template Language:

During a recent system audit, we discovered that your year-to-date payroll contributions for [Medical/Dental/Vision/FSA/etc.] have been underfunded. We will be correcting this error going forward by taking your correct contribution amount plus an additional amount per pay period (for a total combined per-pay period amount of [Enter Amount]) that is designed to ensure you reach your desired salary reduction contribution amount through payroll by the end of the plan year. Please contact People Operations with any questions.

Option #2
Lump Sum Repayment

Employers can choose to correct missed contributions by withholding the amount owed in a single lump sum through one payroll prior to the end of the plan year. Employers should notify employees of this approach in advance so they will be aware of the additional withholding from their payroll to address the retroactive contributions.

Template Language:

During a recent system audit, we discovered that your year-to-date payroll contributions for [Medical/Dental/Vision/FSA/etc.] have been underfunded. We will be correcting this error by taking a one-time corrective contribution amount of [Enter Amount] in an upcoming pay period that is designed to ensure you reach your desired salary reduction contribution amount through payroll by the end of the plan year. This one-time corrective contribution amount will be in addition to your standard per-pay period contribution, which has been corrected. Please contact People Operations with any questions.

Option #3
Forgive Missed Contributions

Employers can choose to forgive the missed employee contributions without requiring the employee to repay the missed amount. This option requires the employer to eat the cost, but it is also the simplest approach and the least likely to cause employee relations issues related to the mistake.

Template Language:

During a recent system audit, we discovered that your year-to-date payroll contributions for [Medical/Dental/Vision/FSA/etc.] have been underfunded. We will be correcting this error by forgiving your missed contributions and withholding your corrected elected contribution amount through payroll for each pay period remaining in the plan year. You will still have access to the full benefits you elected for the plan year. Please contact People Operations with any questions.

04

Use-It-Or-Lose-It

The Basic Rule for FSAs

Use-It-Or-Lose-It Rule

Additional Notes

- **Refunding employees for their specific remaining unreimbursed balance is not permitted**
- Employers almost always apply experience gains from forfeitures to the FSA administrative expenses
- **For the Health FSA:** Experience gains are the result of annual forfeitures reduced by the health FSA's losses from overspent accounts by employees who terminate mid-year (uniform coverage rule)
- **For the Dependent Care FSA:** Forfeitures could likely be retained by the employer because ERISA does not apply (ERISA fiduciary duties prohibit this option for health FSA)

General Rule for FSAs: Section 125 Use-It-Or-Lose-It Rule

- Health FSA and Dependent Care FSA are components of the Section 125 cafeteria plan
- A fundamental limitation is that FSA elections are subject to the use-it-or-lose-it rule
- Means that after the end of the plan year (or earlier termination of participation) and any grace period and/or run-out period, **any remaining unreimbursed funds not subject to a carryover provision must be forfeited to the plan**
    - No option for employers to make exceptions—that would risk all employee elections becoming taxable

Permitted Use of Experience Gains from FSA Forfeitures

The Section 125 regulations generally provide the following permitted plan uses of experience gains resulting from forfeitures:

- To reduce required salary reduction amounts for the immediately following plan year, on a reasonable and uniform basis;
- Returned to employees on a reasonable and uniform basis; or
- **To defray expenses to administer the cafeteria plan.**

Prop. Treas. Reg. §1.125-1(c)(7)

Relevant Cite: Use-It-Or-Lose-It Rule

(7) Operational failure.

i. In general. **If the cafeteria plan fails to operate according to its written plan or otherwise fails to operate in compliance with section 125 and the regulations, the plan is not a cafeteria plan and employees' elections between taxable and nontaxable benefits result in gross income to the employees.**

ii. Failure to operate according to written cafeteria plan or section 125. Examples of failures resulting in section 125 not applying to a plan include the following—

A. Paying or reimbursing expenses for qualified benefits incurred before the later of the adoption date or effective date of the cafeteria plan, before the beginning of a period of coverage or before the later of the date of adoption or effective date of a plan amendment adding a new benefit;

B. Offering benefits other than permitted taxable benefits and qualified benefits;

C. Operating to defer compensation (except as permitted in paragraph (o) of this section);

D. Failing to comply with the uniform coverage rule in paragraph (d) in §1.125-5;

E. Failing to comply with the use-or-lose rule in paragraph (c) in §1.125-5;

F. Allowing employees to revoke elections or make new elections, except as provided in §1.125-4 and paragraph (a) in §1.125-2;

G. Failing to comply with the substantiation requirements of § 1.125-6;

H. Paying or reimbursing expenses in an FSA other than expenses expressly permitted in paragraph (h) in §1.125-5;

I. Allocating experience gains other than as expressly permitted in paragraph (o) in §1.125-5;

J. Failing to comply with the grace period rules in paragraph (e) of this section; or

K. Failing to comply with the qualified HSA distribution rules in paragraph (n) in §1.125-5.

Use-It-Or-Lose-It-Rule: Exceptions to the Rule

There are two main exceptions to the general rule that FSA participants forfeit contributions for which the participant has not incurred eligible expenses by the end of the FSA plan year. There are advantages/disadvantages and important limitations for each.

Grace Period

Optional Health FSA or Dependent Care FSA provision that permits participants to incur claims 2½ months after the end of the plan year

- The grace period is **optional**
- Must check the cafeteria plan document to confirm whether it is available
- For a calendar plan year, grace period permits FSA participants to incur expenses until March 15 of year two
- Can be followed by a run-out period (often 90 days) to submit claims incurred by the end of the grace period

Carryover

The Health FSA may offer the ability to carry over up to $660 (2025 to 2026, indexed) into subsequent plan years

- For the health FSA only—**not permitted under the dependent care FSA**
- The $660 (indexed) carryover is **optional**
- Must check the cafeteria plan document to confirm whether it is available
- **Advantage**: Not limited to 2½ months
- **Disadvantage**: Limited to $660 (indexed)
- Cafeteria plan can provide grace period for dependent care FSA and carryover for health FSA (this is common)

The Health FSA Contribution & Carryover Limits

Salary Contribution Limit: $3,300 for Plan Years Beginning On or After 1/1/2025	**Carryover Limit:** $660 for PY Starting in 2025 to PY Starting in 2026
ACA Original $2,500 Limit Indexed for Inflation • Adjusts in $50 increments based on a complex cost-of-living calculation tied to the chained and standard consumer price index increases for the preceding year • The cost-of-living increases in 2024 were sufficient to boost the 2025 limit by two $50 increments ($100 total) • Means that for plan years beginning on or after January 1, 2025, the health FSA salary reduction contribution limit is $3,300 **Employer Health FSA Contributions:** • Employer contributions do not count toward the $3,300 salary reduction contribution limit • Maximum is generally $500/year (can be higher if structured as a dollar-for-dollar match) • Total max generally $3,330 (EE) + $500 (ER) = $3,800	**IRS Now Indexes the Carryover Limit** • Executive Order 13877 in June 2019 directed the IRS to increase the $500 carryover limit • The IRS announced in Notice 2020-33 that it was increasing the carryover limit to an amount equal to 20% of the maximum health FSA salary reduction contribution • The carryover limit for plan years starting in 2024 to plan years starting in 2025 was at $640 (20% of $3,200) • The carryover limit for plan years starting in 2025 to plan years starting in 2026 is now set at $660 (20% of $3,300) • Reminder: CAA FSA relief provisions permitted full carryovers for both the health FSA and the dependent care FSA for plan years ending in 2020 and 2021 into the subsequent plan years ending in 2021 and 2022, respectively. That provision has now sunset.

How to Handle a Late Health FSA Limit Release

The salary reduction limit for the upcoming year is often released in November after OE has closed, causing some degree of frustration and confusion in how to capture employee election amounts. Here are a few options for how to handle:

Option #1
Map to Maximum

Employers can include a disclaimer in the OE materials and the enrollment system stating that any employee electing the current maximum amount will automatically have their election mapped to the new maximum when announced.

Template Language:

If you elect the current maximum amount of $3,300 during open enrollment and if the IRS changes the limit for 2026 prior to the start of the plan year, we will assume you will want to elect the new maximum amount and will increase your election accordingly. Current projections are that the limit will likely increase to [enter amount] for 2026.

Option #2
Use Projected Limit

Employers can allow employees to elect up to the projected amount for the coming plan year, and include a disclaimer in the OE materials and the enrollment system stating that the election will be modified if the projection is incorrect.

Template Language:

It is currently projected that the $3,300 limit will increase to [enter amount] for 2026. If you elect an amount in excess of $3,300 and the IRS announces that the 2026 limit is less than your election, we will reduce your election accordingly to the maximum permitted. If you elect [enter amount] and the limit is announced to be higher, we will assume you wanted the new maximum amount and increase your election accordingly.

Option #3
Re-Open Elections for Health FSA

Employers can allow employees to elect only up to the current limit, and re-open the enrollment process for a “mini OE” limited to the health FSA election when the IRS announces the increased limit. This process must be completed prior to the start of the plan year to comply with the Section 125 election requirements.

Template Language:

The IRS has not announced the health FSA limit for 2026. If the maximum amount increases, we will re-open the enrollment system prior to the start of the plan year to allow you to increase your election accordingly. In this situation, the only election change permitted will be to increase your health FSA amount, and only if you elected the maximum.

Use-It-Or-Lose-It Rule: Health FSA

Mid-Year Termination of Participation

Employees who lose eligibility for the **Health FSA** mid-year because of a termination of employment or reduction in hours will be faced with the use-it-or-lose-it rule earlier than ongoing employees. They have two options to access unreimbursed contributions.

Option 1: Run-Out Period	Option 2: COBRA
Most cafeteria plans provide for a run-out period to submit FSA claims incurred prior to termination • Typically this period is 90 days-but must check the plan document to confirm • Plan may provide that health FSA coverage (i.e., the ability to incur reimbursable claims) continues through the end of the month in which the employee terminates (similar to many medical/dental/vision plans) • Run-out period will begin whenever health FSA coverage ends	**Coverage for an underspent health FSA can be continued via COBRA through the end of the plan year in which the employee terminates** • An account is underspent if the employee contributed more to the FSA than had been reimbursed at the time of the COBRA qualifying event • COBRA permits the employee to incur reimbursable claims for the remainder of the plan year • If the health FSA has the carryover, COBRA can continue for 18 months

Health FSA: Mid-Year Termination of Participation

Sample Language: Summary of Options to Provide Employees

The company's health FSA is a component of company's cafeteria plan, which is governed by Internal Revenue Code §125. The Section 125 regulations provide that company must follow the written terms of its cafeteria plan document to maintain the tax-advantaged status of employees' health FSA elections.

Upon terminating employment, you lost coverage under the company's health FSA. However, there are two options available to you to access unreimbursed funds remaining in the company's health FSA at the time of your termination:

- ***Option 1: Run-Out Period***

  The company's cafeteria plan provides a 90-day run-out period [CONFIRM IN PLAN DOCUMENT] for terminated employees to submit claims incurred prior to termination. You must follow the plan's procedures to properly submit any outstanding claims within that run-out period.

  At the end of the run-out period, the use-it-or-lose-it rule for health FSAs requires that any unreimbursed funds be forfeited to the plan unless you elect COBRA (see Option #2 below).

- ***Option 2: COBRA Continuation Coverage***

  Upon terminating from employment, you experienced a COBRA qualifying event to continue coverage under the company's health FSA through the end of the plan year. This option will be available to you only if your account was underspent at the time of termination (i.e., you had contributed more than you had been reimbursed at the time of the qualifying event).

  If you timely elect and pay for COBRA continuation coverage under the health FSA, you will be able to continue incurring claims for reimbursement through the end of the plan year. Up to $660 remaining in your health FSA at the end of the plan year will be subject to the plan's carryover provision and may continue to be available for the duration of your maximum COBRA period (18 months from termination). [delete last sentence if plan does not offer the carryover]

OBBB: Dependent Care FSA Increased to $7,500

Increased Limit Effective as of 2026

First Dependent Care FSA Increase in 40 Years

- One Big Beautiful Bill (OBBB) increases limit to $7,500 ($3,750 for married couples filing separately)
- Congress set the dependent care FSA limit at $5,000 in 1986 without indexing it to inflation
- With the exception of a one-year blip (the 2021 ARPA increase to $10,500) the dependent care FSA has been stuck at that level
- If it had been indexed to inflation, the limit would be roughly $14,500
- Increase is big news, but unfortunately it still is not indexed to inflation going forward—another act of Congress is required to lift in future

Section 125 Cafeteria Plan Amendment

- Work with FSA TPA to ensure plan is updated to include the new limit going forward
- Also want to ensure that all dependent care FSA benefit summary materials provided to employees include $7,500 limit

OE Communications Priority

- Given that employees have always had only $5,000 available to them through the dependent care FSA, this will be a welcome surprise for many
  - Ensure OE materials are updated and highlight this change going forward

55% Average Benefits Test Still a Concern

- Highly compensated employees tend to elect the dependent care FSA to a greater degree in general
  - 55% benefits test (see next section) will continue to be a struggle for employers to pass

Future of Dependent Care FSA Limit

- Only Congress can change the dependent care FSA limit
- The OBBB does not include an index for inflation to increase the limit going forward
  - Any additional contribution limit increases going forward will require Congress again—hopefully next time with an index for inflation!

Use-It-Or-Lose-It Rule: Dependent Care FSA

Mid-Year Termination of Participation

Employees who lose eligibility for the Dependent Care FSA mid-year because of a termination of employment or reduction in hours will face the use-it-or-lose-it rule earlier than ongoing employees. They have two options to access unreimbursed contributions.

Option 1: Run-Out Period	Option 2: Spend-Down Provision
Most cafeteria plans provide for a run-out period to submit FSA claims incurred prior to termination • Typically this period is 90 days—but must check the plan document to confirm • Plan may provide that dependent care FSA coverage (i.e., the ability to incur reimbursable claims) continues through the end of the month in which the employee terminates (similar to many medical/dental/vision plans) • Run-out period will begin whenever dependent care FSA coverage ends	**Allows the terminated participant to incur expenses through the end of the plan year (i.e., spend it down)** • The spend-down provision is **optional** • Must check the cafeteria plan document to confirm whether it is available • Many dependent care FSAs do not include the spend-down provision • The option is designed to address the issue of underspent dependent care FSAs because they are not subject to COBRA • COBRA applies to the health FSA, but not the dependent care FSA

05

Nondiscrimination Rules

Multiple Cafeteria Plan Tests Required

Cafeteria Plan Nondiscrimination Rules: *Three Main Sets of Tests*

Standard cafeteria plans that include a pre-tax premium component, Health FSA, and Dependent Care FSA are subject to three sets of nondiscrimination tests that are applicable to employers of all sizes:

1

Section 125 Cafeteria Plan Testing

- Eligibility Test
- **Contributions and Benefits Test**
- Key Employee Concentration Test

2

Section 105(h) Health FSA Testing

- Eligibility Test
- Benefits Test

3

Section 129 Dependent Care FSA Testing

- Eligibility Test
- Contributions and Benefits Test
- More-Than-5% Owner Concentration Test
- **55% Average Benefits Test**

Who Qualifies as Highly Compensated?

Each component of the cafeteria plan nondiscrimination testing has a different definition:

Section 125 Cafeteria Plan (Including Pre-Tax Premiums)

Highly Compensated Participants (HCPs)

1. An officer;
2. A more-than-5% owner of the employer in the current or preceding year; **or**
3. An employee who earned in excess of $155,000 (2025 testing) in the prior plan year

Key Employees (Applicable to Key Employee Concentration Test Only)

1. An officer with annual compensation for the current plan year in excess of $225,000 (2025 testing);
2. A more-than-5% owner; **or**
3. A more-than-1% owner making at least $150,000 (all testing years)

Section 105(h) Health FSA

Highly Compensated Individuals (HCIs)

1. One of the top five highest-paid officers;
2. A shareholder who owns more than 10% of the value of the employer's stock; **or**
3. Among the highest-paid top 25% of all employees in the current plan year

Section 129 Dependent Care FSA

Highly Compensated Employees (HCEs)

1. A more-than-5% owner of the employer in the current or preceding plan year; **or**
2. An employee who earned in excess of $155,000 (2025 testing) in the prior plan year*

**Note: Top 20% alternative may be available via top-paid group election (see slide 46 for more details)*

The Section 125 Contributions and Benefits Test

"Uniform Election Rule" for Different Health Plan Contribution Structures

General Rule:
No Greater Contribution for Highly Compenated Participants

Highly Compensated Participants:

- **An officer;**
- **A more-than-5% owner in the current or preceding year; or**
- **For 2025, an employee who earned in excess of $155,000 in prior year**
- The Uniform Election Rule: "A plan must also give each similarly situated participant a uniform election with respect to employer contributions…." (Prop. Treas. Reg. §1.125-7(c)(2))
- Means that full-time non-HCP employees eligible for the same plan option as an HCP generally must be offered at least the same employer contribution amount that is available to HCPs for that same plan option

Exception:
Regional Contribution Structure

- **Rules permit employers to have different contribution structures for employee classes by region**
- The uniform election rule restrictions apply to "similarly situated participants"
- Means the employer cannot provide a greater contribution for any HCP than any non-HCPs who are "similarly situated participants" eligible for the same plan option
- Definition of "similarly situated" permits the employer to categorize employee groups based on reasonable differences in plan benefits
- Primary example is employees in different geographic locations

Workaround:
Increase Wages for HCPs

- **Never any issue with providing higher compensation to HCPs**
- So employers can provider a greater taxable salary/wage to certain HCPs even though a greater contribution to the health plan is not permitted
- If those employees are paid a greater amount intended to cover all or a portion of the cost of coverage, the employee can then make an election to apply that extra amount on a pre-tax basis to the employee-share of the premium (for same net result)
- Practical result is even though employer cannot favor HCPs in terms of health plan contributions, then can achieve the exact same result through higher pay for those HCPs

Nondiscrimination Rules:
The Dependent Care FSA 55% Average Benefits Test

Dependent Care FSA: 55% Average Benefits Test

- Although this is only one component of the three main tests, it is generally the only one that ever becomes an issue when performing NDT
  - Practical reality is this is the only component of the NDT that employers worry about
  - Nevertheless, employers must still perform all of the NDT from the prior slide to confirm passing result and maintain in records in event of audit
- **The test requires that at least 55% of the dependent care FSA benefits are for non-highly compensated employees (non-HCEs)**
  - This is a very hard test to pass without adjustments to HCE elections

Who Qualifies as a Highly Compensated Employee (HCE)?

- **More-than-5% owners of the employer in the current or preceding plan year**
  - Refers to stock ownership for corporations, capital or profits interest for partnerships and other non-corporate entities
  - Attribution applies to family members such as spouses, parents, children, grandchildren
- **For 2025 Testing: Employees who earned in excess of $155,000 in the prior year (2024)**
  - For 2026 Testing: Increases to employees who earned in excess of $160,000 in the prior year (2025)
  - Employees hired mid-year in the prior year may have annualized salary in excess of $155,000, but still not qualify as HCE because they did not earn $155,000 in the partial year of employment
  - Generally look to Box 1 of the Form W-2 to determine compensation level for prior year
  - Section 125 NDT rules say to use current-year compensation for employees hired in the current year, but not clear whether this special current-year-hire rule applies to this dependent care FSA testing

The Dependent Care FSA 55% Average Benefits Test

Alternative HCE Testing Method: Top-Paid Group Election

- Top-paid group election is an option to consider where the dependent care FSA does not pass the 55% Average Benefits Test
- HCE status is determined by whether employees are in the top 20% highest-paid employees
  - Means that HCEs are **not** determined by the specific annual compensation level under §414(q)
- **Can result in significantly fewer employees meeting HCE status**
  - Employees who earned $155,000+ in the prior year but are not in the top 20% are no longer HCEs
  - The more non-HCEs you have, the better the chance to pass the 55% Average Benefits Test

Important Limitation: Election Must Also Apply to 401(k) Plan

- **The top-paid group election cannot be used for the dependent care FSA NDT unless it is also applied to the employer's retirement plans, including any 401(k) plan**
  - Employers seeking to utilize the top-paid group election must coordinate with 401(k) nondiscrimination testing vendor to confirm that a top-paid group election is in place for that plan year

Relevant Cite

Treas. Reg. §1.414(q)-1, Q/A-9(b)(2)(iii)

(iii) Method of election. The elections in this paragraph (b)(2) must be provided for in all plans of the employer and must be uniform and consistent with respect to all situations in which the section 414(q) definition is applicable to the employer. **Thus, with respect to all plan years beginning in the same calendar year, the employer must apply the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans.** If either election is changed during the determination year, no recalculation of the look-back year based on the new election is required, provided the change in election does not result in discrimination in operation. (emphasis added)

The Dependent Care FSA 55% Average Benefits Test

Pre-Test Early! (Before Q4 if Possible)

- The NDT rules look to the last day of the plan year to determine whether the plan passes
- **A mid-year pre-test will indicate whether the plan will pass on the last day of the plan year**
  - For example, test might show a failing result at 45% that requires a 20% reduction to HCE elections
  - That would require an HCE who elected $5,000 to be capped at $4,000 instead
  - Reducing HCE elections ensures that the plan will pass the test as of the last day of the plan year
- The earlier you test, the more likely HCEs have not already exceeded the reduced cap
  - **Where the HCE has already exceeded the reduced cap, the employer must recharacterize the excess contributions as taxable income before the end of the year to pass as of the last day of the plan year**
  - Far simpler to correct before the HCE reaches the reduced cap by stopping HCEs' contributions at the reduced amount indicated by the pre-test (i.e., payroll cap on contributions for HCEs)

Must Correct By the End of the Year to Pass

- Once the plan year closes, there is no option to correct because the plan will have failed as of the last day of the plan year

Why Testing Matters

Loss of All HCE Pre-Tax Status

- Where the employer fails to make corrections by the end of the plan year, the entire dependent care FSA contributions for all HCEs must be recharacterized as taxable income
  - In other words, the HCE elections are reduced to "0" and the entire contribution amount is taxable
  - The Form W-2 would reflect "0" in Box 10 for dependent care benefits (moved to Box 1 income)

Bottom Line: Cannot wait until January's Form W-2 preparation to address—must recharacterize any excess HCE contributions as taxable income through payroll by the last day of the plan year

Nondiscrimination Rules: Failing the 55% Average Benefits Test

Can Employers Prevent Testing Failures?

The Good

Offer an Employer-Matching Contribution to Non-HCEs

- For example, a dollar-for-dollar matching contribution for non-HCEs of up to $500
- This may entice greater participation from non-HCEs with dependent care expenses
- Again, doesn't guarantee a passing result, but will make it much more likely
- Unfortunately, this is uncommon for dependent care FSAs even though it's very common for 401(k) plans

The Bad

Limit HCE Contributions to a Reduced Level from the Outset

- For example, HCEs may elect up to $3,000 (non-HCEs have the standard $5,000 limit)
- Reduces the likelihood of a testing failure, but not a guarantee (it's just a guessing game)
- We generally do not recommend this approach because it will always result in one of the following:
  - HCEs not being able to take full advantage of the maximum permitted pre-tax election; or
  - Require a slightly smaller correction than would otherwise be required

The Ugly

Permit only Non-HCEs to Participate in Dependent Care FSA

- The advantage is that the test will of course always result in at least 55% of benefits elected by non-HCEs (it will be 100%)
- Needless to say, this isn't very popular among HCEs
- Blocks HCES entirely from dependent care FSA participation when they could have received at least some portion of the $5,000 tax-advantaged benefit

Failing the 55% Average Benefits Test: *What is Best Practice?*

Why Testing Matters

Form W-2 Penalties

- Failure to perform testing and address any testing failures would create a Form W-2 reporting issue for the affected highly compensated employees:
  - $60 per Form W-2 if corrected within 30 days of the 1/31 due date
  - $130 per Form W-2 if corrected after 30 days, but no later than August 1
  - $330 per Form W-2 if corrected after August 1 or not corrected
  - $660+ per Form W-2 if due to intentional disregard of the Form W-2 requirements

Full penalty description: IRS Form W-2 Instructions

- Do not preemptively cap HCE elections, but pre-test early (e.g., Summer or early Fall for a calendar plan year) to determine any reduced contribution limit required to pass
- **This approach ensures that HCEs have the maximum pre-tax benefit available to them**
  - Failing the Average Benefits Test is ok!
  - Early pre-tests will generally catch the issue before HCEs have contributed up to the reduced limit
  - The administrative burden is relatively minor where adjustment is simply a payroll contribution cap for HCEs to avoid exceeding the reduced limit

Wrap-Up

Takeaways

Section 125 Cafeteria Plans

Top Takeaway:

The general rule under Section 125 for ongoing employees is that all elections (including an election not to participate) must be:

1. Made prior to the start of the plan year; and
2. Irrevocable for the duration of the plan year unless the employee experiences a permitted election change event.

1

Why does Section 125 matter?

- Only a Section 125 cafeteria plan can prevent employees from constructive receipt of taxable cash
- The cafeteria plan prevents employees from being taxed on the available cash compensation that they instead elected to direct to non-taxable health and welfare benefits
- Employee pre-tax premium and FSA contributions require a cafeteria plan!

2

Plan document requirements

- Must have a written plan document with specific content requirements
- Section 125 cafeteria plans must be adopted, amended, and restated prospectively to be effective (i.e., signed on or before effective date)

3

Making/changing elections

- Section 125 imposes very strict rules on when employees are permitted to make their elections and change them mid-year
- Failure to follow can result in the entire cafeteria plan losing its tax-advantaged status, resulting in all elections becoming taxable for employees

4

The Use-It-or-Lose-It rule

- A fundamental rule for FSAs is that they are subject to use-it-or-lose-it
- Section 125 spells out specific permitted uses for FSA experience gains
- Employees hate this rule, and there are always requests for exceptions, but employers should not jeopardize plan's tax-advantaged status
- FSA features such as grace periods and carryovers can reduce the potential for participant forfeitures
- ***New for 2026: OBBB increases dependent care FSA limit to $7,500 (work with TPA to implement)***

5

Nondiscrimination testing

Three basic categories of NDT:

- Section 125 Cafeteria Plan
- Section 105(h) Health FSA
- Section 129 Dependent Care FSA

Reality is that the 55% Average Benefits Test component of the dependent care FSA test is the only one that employers fail

- Conduct early mid-year pre-testing (before Q4) where possible to determine any required reductions to HCE elections well in advance of end of year
- Top-paid group (Top 20%) election may help pass where available

Content Disclaimer

Section 125 Cafeteria Plans

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Thank you

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