Envita™ HEALTH

Section 125 Cafeteria Plans

2024 Edition

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Guide 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 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

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., $3,200 health FSA in 2024, $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

Envita Health Section 125 cafeteria plan permitted election change event chart

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.

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 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

1

2

3

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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2
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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 mistake 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.

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.

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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 direct to non-taxable health and welfare benefits
- Employee pre-tax premium and FSA contributions require a cafeteria plan!

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)

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

Content Disclaimer

Section 125 Cafeteria Plans

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Mr. Gustafson is a seasoned healthcare lawyer with over 22 years of practice entirely devoted to healthcare law and representing large healthcare entities such as hospital systems, insurance companies and many others in the healthcare space. Mr. Gustafson has specific experience establishing, funding, managing, and performing risk mitigation for both 831a and 831b captive insurance companies. In doing so he is adept at working with IRS and tax regulations, insurance and domicile regulators, actuarial analyses, litigation matters, and many other issues that face corporate healthcare today.

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