Advanced Cafeteria Plans

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Advanced Cafeteria Plans

- Review of the Basics
- Managing "Use it or Lose it" and Other Forfeiture Issues
- Health Savings Accounts and Limited Purpose Flexible Spending Accounts
- Cash in Lieu of Benefits/Flex Credits
- Nondiscrimination Testing

- IRS regulations cover a wide variety of plan designs and options for employers; this webinar focuses on options that are supported by the BESTflex Plan administered by Employee Benefits Corporation.
- This webinar does not constitute legal advice and should not be relied upon as such.

5

Review of the Basics

6

What is a Cafeteria Plan?

- Choice between tax-free benefit and taxable compensation
- Established under Internal Revenue Code § 125
- Provides both employers and employees a tax break
- Employees make irrevocable elections for most choices
- Must be established in writing
- Employees are directing how the employer is going to spend money on benefits – it's the employer's money

Eligible benefits

- Qualified Insurance Premiums (examples)
  – Group health coverage (medical, dental, vision, illness, Rx)
  – Employee-only Group Term Life (up to $50,000)
  – Disability
  – Individual insurance <u>except</u> major medical
  – Voluntary insurance (e.g., cancer care) - but consider ERISA

Eligible benefits

- **Affordable Care Act prohibits reimbursement or payment of major medical insurance other than the employer's group health plan coverage in Cafeteria Plan**
  - Restriction applies to "active employees"
  - No reimbursement or direct payment of individual medical insurance premiums
- **Cannot reimburse insurance premiums through Health FSA (never could) – must use separate individual insurance reimbursement account for qualified non-medical premiums**

 9

Eligible benefits

- **Can reimburse or pay COBRA premiums pre-tax under some circumstances – Must be in Plan document!**
  - Reduction in hours: probably not, because often part-time employee no longer eligible for Cafeteria Plan
  - Child ages off plan– probably could permit pre-tax COBRA payments for gap year
  - Ex-Spouse – no, because the former spouse is no longer eligible under Cafeteria Plan
  - COBRA from former employer during waiting period (or beyond) – maybe. Seems permitted by proposed Cafeteria Plan regulations (assuming new employee is eligible for Cafeteria Plan) but may create a 1-person group health plan with unique COBRA rights.

 10

Eligible benefits

- Flexible Spending Arrangements (FSAs)
  – Health FSA
  – Dependent Care FSA (Dependent Care Assistance Plan - DCAP)
  – Individual Premium Reimbursement Account (IND FSA)
    - Not OK for individual major medical coverage
- Health Savings Account (HSA) contributions
- Paid Time Off buy/sell
- Additional payment for waiving benefits (Cash-in-Lieu of benefits)

 11

Eligible benefits

- DO NOT Include
  – Educational assistance
  – Transportation Reimbursements
  – Health Reimbursement Arrangements

 12

Managing "Use it or Lose it" and other Forfeiture Issues

Uniform Coverage Rule

- Health FSA is subject to "Uniform Coverage"
  - Acts as a small, self-funded health plan
- The payroll contribution is a "premium" payment
- The annual election amount is the "maximum benefit"
- A participant may use the coverage on Day 1 through Day 365, and hit the maximum benefit at any time
- Excess premium is not returned, and up to the maximum benefit is paid even if the full premiums are never recouped

Employer Risk from Uniform Coverage

- **Employee can exhaust account early in plan year, then leave employment**
- **Employer has to offer COBRA on Health FSA if not over spent, so employee could elect COBRA to cover expenses yet to be incurred**
  - Integrated FSA with employer contribution could trigger full COBRA Benefits
  - Many plan designs will allow a “limited” offer of COBRA
- **In reality, the risk is low; most participants make up by end of year**
  - $2,550 maximum (2016 limit) reduces risk per participant; can set lower max
  - Any loss is usually offset by experience gains via forfeiture
  - Employer cannot eliminate this risk of loss by requiring payment at termination

Employer Risk from Uniform Coverage

- **Limit COBRA Exposure by Plan Design**
  - Health FSA is only offered to those eligible for employer’s major medical plan, and
  - Employer contributes no more than the greater of:
    - **$500, or**
    - **An amount equal to the employee’s Health FSA election**
  - Structured this way, the plan will always be an Excepted Benefit for Affordable Care Act purposes
  - Limited COBRA offering allows employers to:
    - **Offer COBRA only if account is not overspent**
    - **Offer COBRA only until the end of the Cafeteria Plan Year**

Employee Risk from Use it or Lose it

- **Employees must use the entire benefit they elected by the end of the plan year or they "forfeit" the unused amount**
- **Elections must be made prospectively and cannot be changed; can be hard to estimate**
  - Change of status rules are exceptions and often surprises
- **Unlike Uniform Coverage rule, Use it or Lose it also applies to DCAPs**
- **Forfeitures can lead to low employee participation and satisfaction, and the employer ends up paying more tax**

 17

Employee Risk from Use it or Lose it

- **Run-Out Period**
  - Employer elects a time period after the Plan year end during which the employee can submit claims incurred during the Plan year
  - Usually 3 months, usually applies to terminating employees as well
  - Gives employees more time to get claims in, but doesn't help if employee has no claims to submit
- **Grace Period**
  - IRS allows up to 2 ½ months after the end of the Plan year for an employee to incur new claims on prior year election
  - Employer must elect this option and include it in its Plan document
  - Will typically run concurrently with Run-Out Period, Grace Period claims must be submitted by end of Run-Out Period

 18

Employee Risk from Use it or Lose it

- **Health FSA Rollover/Carryover (IRS Notice 2013-71)**
  - Rollover allows employee's unused Health FSA funds (up to $500) from the previous year to be deposited into new Plan year FSA
  - A Plan **cannot have both** Rollover and Grace Period
  - Cannot be added to DCAP (but Grace Period can)
  - Employer must amend the Plan to allow Rollover
  - Participant need not make a Health FSA election for new Plan year to receive Rollover from prior Plan year – but will create a Health FSA in new Plan year

 19

Employee Risk from Use it or Lose it

- **Rollover/Carryover (Continued)**
  - Employees or qualified beneficiaries (QBs) who were enrolled in the health FSA on the last day of plan year are eligible for Rollover
  - Rollover dollars are in addition to participant's new Plan year Health FSA election (can be on top of $2,550 maximum)
  - Rollover can affect HSA eligibility if employer offers High-Deductible Health Plan due to new Health FSA Plan benefit

 20

Employee Risk from Use it or Lose it

- **Rollover/Carryover impact on COBRA**
  - Rollover is determined by participation on the last day of the plan year
  - COBRA qualified beneficiaries who continued the Health FSA have access to Rollover at year end if active employees do
  - Employees terminated in last month of Plan year may have access to Rollover (even though they don't elect COBRA) if employer deducts full month from payroll and keeps them on the FSA
    - **Since an FSA participant ceases to be an active participant as of the date of termination, this is similar to making an automatic COBRA election for a partial month**
    - **Employers should be mindful of payroll practices and discuss with TPA**

Employee Risk from Use it or Lose it

- **Rollover/Carryover impact on COBRA (IRS Notice 2015-87)**
  - Employees terminated during the year who have Rollover dollars in their Health FSA raise special considerations
  - Ruling clarified that Rollover amounts are not taken into account for calculating COBRA Premium (premium already taken)
  - However, Rollover amounts are included in determination of overspent account: Remaining deposits > Remaining balance (including Rollover) = Overspent, don't need to offer COBRA
  - Effect is that Rollover only accounts will always be offered COBRA if there's a balance

Managing Forfeitures

- **IRS views Plan forfeitures as "Experience Gains"**
  - Overspent Health FSAs are thus "Experience Losses"
  - Will not have experience gains if losses cover the difference
- **Employers have options to deal with Experience Gains**
  - Offset overspent Health FSAs
  - Offset administrative fees for the Plan
  - Disburse to employees as taxable income – NOT in proportion to amounts used
  - Disburse in new Plan year as Employer contribution reducing salary reductions
  - Retained by Employer if Health FSA is not an ERISA plan
- **Forfeiture procedure must be detailed in Plan Document**

 23

Health Savings Accounts and Limited Purpose Flexible Spending Accounts

 24

What is a Health Savings Account?

- **Allows tax-free savings for reimbursement or payment of eligible health-related expenses**
- **Individual banking account – not a "health plan"**
- **Owned by Employee – not "employer-sponsored"**
- **HSA Account holder MUST:**
  - Have qualified High-Deductible Health Plan (HDHP)
    - **Minimum Deductible: Single $\geq$ \$1,300 / Family $\geq$ \$2,600**
    - **Maximum Out of Pocket: Single $\leq$ \$6,550 / Family $\leq$ \$13,100**
  - Have no other disqualifying coverage
- **If requirements not met, individual is not eligible to contribute to HSA and all contributions during period are taxable + 6% excise tax**

What is "Disqualifying Coverage"?

- **Any health coverage that provides coverage for the HSA Account Holder before the statutory minimum deductible is met**
- **Not Permissible – if Account Holder can get benefits from**
  - General purpose HRA coverage below statutory deductible/General Purpose Health FSA – if participating in Plan, even after balance is exhausted
  - Spouse's or Parent's Plan that is not an HDHP
  - Medicare, Medicaid, TRICARE, individual health insurance, some VA benefit recipients, on-site clinics
- **Certain benefits such as discount cards, specified disease policies, dental, vision, and accident coverage are not disqualifying**

Compatible FSA Coverage under Cafeteria Plan

- **Advent of "Limited Purpose Health FSA"**
  - Covers only dental and vision expenses
  - Most attractive to employers with HDHPs
  - Allows HSA account balances to grow, while paying for ongoing dental or vision expenses tax-free
  - Can be offered alongside General Purpose Health FSA – most common if offering both HDHP and traditional coverage
- **HSA eligibility burden is on Employee, but Employer allowing pre-tax HSA contributions AND pre-tax General Health FSA elections will have tax adjustment/withholding and employee relation problems!**

 27

Common Pitfalls with Health FSA/HSA Compatibility

- **Grace Period**
  - If employee has $0 Health FSA balance (not pending) on last day of Plan, eligible in next Plan year day 1 (assuming no election)
  - If employee has anything left at end of Plan year, not eligible for HSA until 1st of month after Grace Period ends
- **Rollovers**
  - If employee has $0 Health FSA balance on last day of Plan (incl. run-out), eligible in next Plan year (assuming no election)
  - If employee has anything left at end of Plan year, not eligible for HSA for <u>entire</u> subsequent Plan year, unless:
    - **Plan allows employees to carryover to Limited Purpose Health FSA (new year election into Limited Purpose Health FSA may be required)**

 28

Climbing out of the Pit

- **Awareness and communication of interaction**
  - Timing issues (when does HDHP become effective vs. when can an HSA be opened/funded?)
  - Other Plans might affect employee eligibility - communication is key because employees must self-monitor
- **Plan amendments**
  - Removing Rollover/Grace Period
  - Adding Limited Purpose Health FSA
  - Allowing Rollover deposit into Limited Health FSA (w/new election)
- **Monitoring obvious account conflicts**

 29

Cash in Lieu of Benefits/Flex Credits in a Cafeteria Plan

 30

Cash in lieu of benefits

- Employer provides a cash payment for not enrolling in a group plan (e.g., $50 per month for not enrolling in health insurance)
- Important to obtain proof of other group health plan coverage if providing additional cash payment for waiving coverage
- Offer on a widespread basis to avoid violating other laws/rules

 31

Flex Credits

- **Employer determines how much will be spent on benefits up front, employees choose how to spend**
- **Employer contribution is fixed and may be based upon lowest cost option with the employee option to "buy-up"**
- **Benefits chosen in excess of employer contribution are purchased through pre-tax salary reduction**
- **Often thought of as "True" Cafeteria Plan or Flex Credits**
- **Employer options:**
  – Elective Contributions – Employee sets allocation
  – Non-Elective Contributions – Employer sets allocation
  – Cashable /Noncashable Contributions

 32

Affordable Care Act issues with Flex Credits

- **Only affects Applicable Large Employers (50+ full time employees)**
- **Flex credit can affect "affordable" coverage**
- **Flex Credit counts as Employer Contribution to health plan if:**
  – No cash out option; cannot receive any of flex credit as cash
    - **Additional calculation for amount of cashable credit if cash-in-lieu**
  – Can use flex credit to pay for minimum essential coverage (major medical coverage is a choice)
  – Can only be used to pay for § 213 medical expenses
    - **Careful of use of flex credits for DCAP, life/disability insurance**
    - **Calculate credits for medical and non-medical separately**

 33

Elective Employer Contributions - Example

- **ABC Company has a Cafeteria Plan that allows pre-tax employer-sponsored medical insurance, dental insurance, Health FSA and DCAP. ABC provides an Elective employer contribution of $400 per month that can be used towards any of the benefit options in the Cafeteria Plan subject to a limit of $40/month toward a Health FSA. Any unused amount is forfeited.**
  – Sally chooses to pay for her entire single health coverage contribution at $250 /month and single dental coverage of $30/month. She has no children, and decides to put the maximum remaining $40 /month in the Health FSA.
    - **The leftover $80/month is forfeited.**
    - **Even though she allocated $480 to her Health FSA, she can still elect the $2,550 max for the Health FSA on her own by pre-tax salary reduction and have a benefit of $3,030 for the year**

 34

Elective Employer Contributions – Example (continued)

– Max chooses family coverage, which costs $950 /month, so he applies the entire $400 toward it.
  - **He makes a pre-tax salary reduction for the remaining $550/month premium payment**
  - **He additionally elects the maximum amount in Health FSA and DCAP by pre-tax salary reduction**

– If either Sally or Max experiences a qualified change of status during the year, the entire contribution structure could be changed in accordance with the rules

Non-Elective Employer Contributions - example

- **DEF Company has a Cafeteria Plan that allows pre-tax employer-sponsored medical insurance, dental insurance, Health FSA and DCAP. DEF provides a Non-Elective employer contribution of $200 /month for single health coverage, $400 /month for family health coverage, and up to $50 /month for single or family dental. It also puts a seed amount of $100 in each employee's Health FSA if they choose to make a pre-tax election of their own.**
  – Sally chooses single health ($250/month) and single dental coverage ($30/month), and elects to contribute $120 annually ($10/month) to a Health FSA, with no DCAP.
    - **She elects salary reduction of $50 per month for the remaining employee contribution to her health coverage, loses the extra $20 of dental contribution and has a $220 annual Health FSA maximum benefit.**

Non-Elective Employer Contributions – example continued

– Max chooses family coverage ($950 /month) and pays for the difference with pre-tax elections. He has better dental coverage through his spouse, so he foregoes the $50 dental contribution.

- **He pays for the remaining health premium , and elects the maximum amount in Health FSA and DCAP by pre-tax salary reduction.**
- **Max can exceed the employee maximum for the Health FSA by adding the $100 employer seed money to it.**

– If Sally or Max experience a qualified change of status during the year, they can change their contribution in accordance with the rules, but can only change the employer contribution if eligibility changes (e.g., Sally gets married and is eligible for family coverage and higher contribution)

Cashable vs. Noncashable Flex Credits

- **If any part of the credits can be received as taxable income:**
  – The amount of employer contribution directed to the Health FSA, DCAP, Health Savings Account or IND account is included in any maximum that applies to that account
  – Affordable Care Act issues for ALEs with cashable credits:
    - **Must add total amount of flex credit to the regular employee contribution for calculating affordability**

Cashable vs. Noncashable Flex Credits

- **If no part of the credits can be received as taxable cash income:**
  - The amount of employer contribution directed to the Health FSA is not included in the employee's pre-tax election maximum (i.e. on top of $2,550)
  - The amount of employer contribution directed to DCAP, Health Savings Account or IND account is included in any maximum that applies to the account.

 39

Nondiscrimination Testing

 40

IRS Requirements

- **Reminder: Certain individuals cannot participate in Cafeteria Plan at all**
  - Self-employed individuals (but sometimes employee-family members can)
  - More than 2% shareholder of an S Corp (or spouse/family)
  - Partners in Partnership
  - Owners and outside directors
- **Plan cannot discriminate in eligibility and benefits in favor of highly compensated employees/individuals (multiple definitions)**
- **Mandated testing at end of each plan year**
- **Cafeteria plans with FSA options have 9 required tests**
  - Premium Only Plan has 3 tests
- **Test and results may be requested during IRS audit**

 41

What if a Plan Fails?

- **Consequence of operating a discriminatory plan is that benefits offered under that plan will be taxable to the highly compensated person**
- **Pre-testing during the Plan year can identify potential failures and reasons for failure**
  - Employer can generally change participant elections to correct a potential plan failure if done during the Plan year
  - Failure discovered after Plan year end must result in taxation

 42

Required Nondiscrimination Testing

- Health FSA (Section 105)
  - Eligibility Test *
  - Benefits Test
- Dependent Care FSA (Section 129)
  - Eligibility Test
  - Contributions and Benefits Test
  - 55% Average Test *
  - 25% Owner Concentration Test
- Cafeteria Plan (Section 125)
  - Eligibility Test
  - Contributions and Benefits Test *
  - 25% Concentration Test (key employee test) *

*Tests that result in most frequent plan failures

 43

Required Testing – Health FSA (§ 105)

- Eligibility Test
  - Reasons for Failure
    - Health Care FSA participation top-heavy
    - Includes top 25% by pay regardless of compensation or authority as "highly compensated"
  - Options to avoid failure
    - Increase participation among lower-paid
    - Decrease participation among higher-paid
    - Limit eligibility to only full-time employees
    - Offer an employer contribution for all eligible employees into a Health Care FSA

 44

Required Testing – Dependent Care FSA (§ 129)

- **55% Average Test**
  - Reasons for failure
    - **Very small percentage of employees are owners or highly compensated individuals and one of them participates**
    - **Not many non-highly compensated individuals elect Dependent Care FSA**
  - Options to avoid failure
    - **Owners and highly compensated individuals do not participate**
    - **Owners' and highly compensated individuals' maximums are reduced based on preliminary test findings**
      - Constant monitoring in case of election changes
      - Constant monitoring in case of new hires
      - Can only modify by reducing election during plan year

Required Testing – Cafeteria Plan (§ 125)

- **Contributions and Benefits Test**
  - Safe Harbor pass if company pays 75% or more of every health plan premium for every eligible employee
  - Reasons for failure
    - **Owner, officer, and highly compensated individuals comprising large percentage of the pre-tax insurance premiums**
    - **Owner and/or officer participates in pre-tax insurance premiums and the disparity in compensation with other employees is not great**
  - Options to avoid failure
    - **Increase participation in pre-tax insurance premiums**
    - **Avoid 100% employer-paid single insurance plans**
    - **Increase owner and/or officer compensation**
    - **Owner and/or officer pay share of insurance premiums post-tax**
    - **Decrease eligibility of employees**

Required Testing – Cafeteria Plan (§ 125)

- 25% Concentration Test (Key Employee test)
  - Reasons for failure
    - Key Employees participate to a more than 25% extent in total Cafeteria Plan benefit plans
    - Not many employees have pre-tax insurance or FSA elections
  - Options to avoid failure
    - Key Employees pay portion of insurance premiums post-tax
    - Avoid 100% employer-paid single insurance plans

 47

Questions?

- Any questions can be addressed by e-mail or phone at your convenience

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 48