

SEC. 125 "CAFETERIA" FRINGE BENEFIT PLANS QUESTIONS AND ANSWERS

The following is provided to answer questions frequently asked concerning a Cafeteria Plan under Internal Revenue Code Section 125. This information is not intended as a substitute for specific legal advice from competent counsel on a specific factual situation. For more information, please refer to your employer's Section 125 Plan Document.

Q-1 WHAT IS A SEC. 125 "CAFETERIA" FRINGE BENEFIT PLAN?

A-1 Sec. 125 of the Internal Revenue Code allows an employer to establish an employee benefit plan whereby employees may make a choice between various benefits that are offered under the plan. These benefits may be purchased by employer contributions or by the employee reducing his or her salary to purchase the benefits that the employee selects. In either case, the employee receives the selected benefits **free of federal and state income taxes and social security taxes (FICA)** since the benefits are purchased with pre-tax dollars.

Q-2 WHAT ARE THE TAX ADVANTAGES OF A SEC. 125 PLAN?

A-2 Since most Sec. 125 benefits are purchased by a reduction in an employee's salary, the employee will reduce his or her taxable income by the cost of the benefit or benefits selected. This means that you will save income taxes on these benefits at your highest federal and state income tax bracket. Also, you do not pay FICA taxes on these benefits. At 25% federal income tax, 6.5% state income tax and FICA taxes of 7.65%, you could save over 35% in taxes for each dollar used to purchase Sec. 125 benefits.

Q-3 HOW MAY AN EMPLOYER ESTABLISH A SEC. 125 PLAN?

A-3 First, an eligible employer must adopt a Sec. 125 plan for its employees. In adopting a plan, the employer must establish a plan year. At the beginning of the first and succeeding plan years, the employees are given an opportunity to participate in the Sec. 125 plan by completing a benefit selection form. The benefit selection form must be completed prior to the beginning of the plan year.

Q-4 WHAT BENEFITS ARE AVAILABLE UNDER A SEC. 125 PLAN?

A-4 Benefits that an employer may make available under Sec. 125 plan on a "before-tax" basis can include: group term life insurance up to \$50,000, health insurance (including hospitalization, dental, vision, disability income, accidental death and dismemberment, indemnity coverages such as cancer and dread disease, and heart and stroke insurance) and flexible spending accounts for reimbursement for non-insured medical expenses and dependent care.

Excess life insurance above \$50,000, long term care insurance, and other benefits might also be available on an "after-tax" basis under a Sec. 125 plan.

Q-5 HOW DOES A FLEXIBLE SPENDING ACCOUNT WORK?

A-5 Flexible Spending Accounts (FSA's) cover two areas. An employee can set aside, on a "before-tax" basis, money to be reimbursed to the employee to cover medical expenses that aren't covered by their health insurance. The expenses would include such items as insurance deductibles, insurance co-payments, orthodontic expenses and other health related items. (They do not include health insurance premiums such as premiums to be paid for health insurance under a spouse's health insurance plan.)

Dependent care expenses of up to \$5000 may be set aside on a "before-tax" basis for childcare. This benefit is for children under age 13 and the care must be provided so that the parent may work or look for work. Payments may not be made to immediate family members such as your spouse or to

children under age 19. Dependent care expenses may also be set aside for a dependent spouse or parent who qualifies as your dependent for income tax purposes.

Money set aside for medical reimbursement cannot be used for dependent care expenses and money set aside for dependent care expenses cannot be used for medical reimbursement expenses.

You should review these benefits carefully each year and set aside only the amount of money that you are sure that you can use in each area. Monies not expended in these accounts are returned to your employer and cannot be returned directly to you.

Q-6 WHAT HAPPENS IF MY SPOUSE OR I BECOME ELIGIBLE FOR MEDICARE COVERAGE DURING THE PLAN YEAR?

A-6 The Internal Revenue Service has indicated that you are eligible for an election change if you or your spouse becomes eligible for Medicare benefits during the plan year.

Q-7 WHEN DO MY BENEFITS BEGIN?

A-7 Generally, your benefits become available at the beginning of the plan year. Some of your insurance coverages may have a requirement that you be actively at work at the beginning of the plan year for your benefits to begin. New employees who are eligible to enroll during the plan year will usually begin their benefits on the first of the month following enrollment. Your employer's plan will dictate eligibility and the beginning date for benefits you choose.

Q-8 WHEN MUST I NOTIFY MY EMPLOYER IF THERE IS AN ERROR IN MY ENROLLMENT?

A-8 Originally, the Internal Revenue Service took the position that all errors must be corrected before the beginning of the plan year. Recent discussion with the Internal Revenue Service has indicated that you would have to notify your employer of any error upon your first identification that an error exists. Presumably this would mean when you receive your first paycheck indicating the error.

Q-9 IF I PURCHASE PART OF MY SEC. 125 BENEFITS ON AN "AFTER-TAX" BASIS, MUST I FOLLOW THE "CHANGE IN FAMILY STATUS" RULES FOR THESE BENEFITS?

A-9 Sec. 125 plans allow both taxable and non-taxable benefits. If a taxable benefit is a part of a Sec. 125 plan, you must follow all of the rules of the Sec. 125 plan in making election changes.

Q-10 MAY I PURCHASE A TAX-SHELTERED ANNUITY UNDER MY SEC. 125 PLAN?

A-10 Tax-sheltered annuities are not an eligible benefit under a Sec. 125 plan. However, you can purchase a tax-sheltered annuity under the rules applicable to Sec. 403(b) of the Internal Revenue Code.

MAKING CHANGES UNDER YOUR SECTION 125 PLAN

The following is provided to answer questions frequently asked concerning a Cafeteria Plan under Internal Revenue Code Section 125. This information is not intended as a substitute for specific legal advice from competent counsel on a specific factual situation. For more information, please refer to your employer's Section 125 Plan Document.

Q-1 MAY I CHANGE MY BENEFIT ELECTION DURING THE PLAN YEAR?

A-1 The Internal Revenue Service regulations for Sec. 125 plans provide specific rules about changes during a plan year. The rules provide a two-step analysis for determining whether an employee can change his or her election during the year. First, a **change in status event** must have occurred. Second, the employee's requested election change **must be consistent with the event**. Following is a list of the qualified status change events.

1. **Change in employee's legal marital status** — including marriage, divorce, death of spouse, legal separation, and annulment.
2. **Change in number of dependents** — including birth, adoption, placement for adoption, and death. Note that dependent is formally defined in the final regulations to be a tax dependent.
3. **Change in employment status** — any of the following events that change the employment status of the employee, the employee's spouse or the employee's dependent would qualify: a termination or commencement of employment; a strike or lockout; a commencement of or return from an unpaid leave of absence; and a change in worksite. In addition, if the eligibility conditions of the benefit plan of the employer of the employee, spouse or dependent depend on the employment status of that individual and there is a change in that individual's employment status with the consequence then that individual becomes (or ceases to be) eligible under the plan, then that change constitutes a change in employment. It is significant to note that this category would not apply if benefit eligibility is not gained or lost as a result of the event. Thus, for example, an individual who moves from full-time to part-time employment status would not be able to change his or her election under this rule if benefit eligibility remains the same.
4. **Dependent satisfies (or ceases to satisfy) dependent eligibility requirements** — an event that causes the dependent to satisfy or cease to satisfy the requirements for coverage due to attainment of age, gain or loss of student status, marriage or any similar circumstances.
5. **Residence change** — a change in the place of residence of an employee spouse or dependent. For this category, it is particularly important to remember that the residence change **must** affect the employee's eligibility for coverage.
6. **Adoption Assistance**: Commencement or termination of adoption proceedings would allow an election change under an adoption assistance program.

The Consistency Requirement

If a change in status event occurs, employees are allowed to make **changes consistent with the event**. The regulations limit the election changes that will be consistent with the event. Under the regulations, a uniform rule generally applies to all qualified benefits (accident or health coverage and group term life).

The threshold question under the consistency requirement is whether the election change is on account of and corresponds with a change in status event that affects coverage eligibility of the employee, spouse or dependent for the qualified benefit. An important exception to this general rule is that an impact on eligibility is not required for marital status or employment status events to support election changes for group term life insurance or long-term disability coverage.

Once the threshold standard is met (i.e., the event affects eligibility), **two specific consistency tests must be satisfied** — one when dependent eligibility is lost and another when coverage eligibility is gained through another employer plan. In addition, the regulations have been expanded to recognize that certain changes in life or disability coverage can be consistent even if the requested change does not track the increase or decrease in family size, or result in the gain or loss of eligibility.

If the change in status is the employee's divorce, annulment or legal separation from a spouse, the death of a spouse or dependent, or a dependent ceasing to satisfy the eligibility requirements for coverage, the

employee can only cancel accident or health insurance coverage for the spouse or dependent, as applicable. Thus, if a dependent dies or ceases to satisfy the eligibility requirements for coverage, the employee's election to cancel accident or health coverage for any other dependent, for the employee or for the employee's spouse fails to correspond with that change in status.

If an employee, spouse or dependent gains eligibility for coverage under another employer's cafeteria plan (or qualified benefit plan) as a result of a change in marital status or a change in employment status, an employee's election under the cafeteria plan corresponds with that change in status only if coverage for that individual becomes effective or is increased under the other employer's plan.

Q-2 WHEN MUST I NOTIFY MY EMPLOYER IF I HAVE HAD A "CHANGE IN STATUS EVENT"?

A-2 Any change of election because of a change in status event must be made within 30 days of the qualifying event.

Q-3 WHAT HAPPENS IF THERE IS A CHANGE IN COST OR COVERAGE DURING THE PLAN YEAR?

A-3 Mid-year election changes are permitted on account of certain mid-year cost and coverage changes, as provided under IRS Section 125 regulations. It should be noted that these provisions do not apply to health Flexible Spending Accounts.

Changes in Cost

If the cost of a qualified benefits plan decreases during a period of coverage and, under the terms of the plan, employees are required to make a corresponding change in their payments, the cafeteria plan may, on a reasonable and consistent basis, automatically make a prospective decrease in affected employee's elective contributions for the plan. If the cost of a benefit significantly increases during a period of coverage, the cafeteria plan may permit employees either to make a corresponding prospective increase in their payments, or to revoke their elections and, in lieu thereof, to receive on a prospective basis coverage under another benefit package option providing similar coverage.

Change in Coverage

Coverage Change Rule #1: Significant curtailment

If the coverage under a plan is significantly curtailed or ceases during a period of coverage, the cafeteria plan may permit affected employees to revoke their elections under the plan and make a new election for coverage under another benefit package option providing similar coverage. Coverage under an accident or health plan is significantly curtailed "only if there is an overall reduction in coverage provided to participants under the plan so as to constitute reduced coverage to all participants generally."

Coverage Change Rule #2: Addition (or elimination) of benefit package option

If during a period of coverage a plan adds a new coverage option (or eliminates an existing option) the cafeteria plan may permit affected employees to elect the newly added option (or elect another option if an option has been eliminated) prospectively on a pre-tax basis and make corresponding election changes with respect to other benefit package options providing similar coverage.

Coverage Change Rule #3: Change in coverage of spouse of dependent under their plan

A cafeteria plan may permit an employee to make a prospective election that is on account of and corresponds with a change made under the plan of the spouse's, former spouse's, or dependent's employer if: (1) a cafeteria plan or qualified benefits plan of the spouse's, former spouse's, or dependent's employer permits participants to make an election change that would be permitted under the proposed and final regulations; or (2) the cafeteria plan permits participants to make an election for a period of coverage that is different from the period of coverage under the cafeteria plan or qualified benefits plan of the spouse's, former spouse's, or dependent's employer. Under either option, a consistency requirement must be satisfied since the new election must be on account of and corresponds to the change under the plan of the spouse's, former spouse's, or dependent's employer.