

# Employers Must Document and Test Cafeteria Plan Benefits, POPs Included

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By offering a cafeteria plan, an employer can help employees pay various expenses, such as the employee's premium contribution for group health insurance coverage, on a pre-tax basis. A cafeteria plan provides employees the opportunity to apply a portion of their compensation toward one or more non-taxable benefits in lieu of receiving that amount in their paychecks as taxable compensation. Amounts so applied escape federal income taxation, and depending on the benefit, may also avoid FICA or state and local income taxation.

## **Cafeteria Plans Must be in Writing**

A cafeteria plan that offers only premium conversion benefits (i.e., the opportunity to apply a portion of employee compensation toward the payment of premiums for medical, dental, vision, group term life, disability, or accidental death and dismemberment insurance) is commonly referred to as a premium only plan ("POP"). Some employers offer premium conversion to their employees, often in connection with group health insurance, outside of a cafeteria plan. Contrary to what many such employers and their employees may believe, premium conversion amounts are fully taxable in these circumstances.

A fundamental requirement of a POP or of any cafeteria plan, and of the tax benefits associated with such a plan, is that the plan be maintained pursuant to a formal written document adopted by the employer. Until a legally sufficient cafeteria plan document is in place and the employee enrolled pursuant to its terms, premium conversion amounts will be taxable to the employee, even though applied toward contributions for an otherwise non-taxable benefit such as employer-provided group health insurance. The plan document must satisfy numerous detailed requirements, as elaborated in Internal Revenue Code Section 125, its implementing regulations, and other official IRS guidance relating to cafeteria plans, most of which are beyond the scope of this article. Qualified counsel should be consulted concerning the establishment of any cafeteria plan.

Aside from premium conversion, a cafeteria plan may include features permitting, among other benefits, tax-free (i) self-reimbursement of certain medical expenses, such as health plan deductibles, co-pays, and uninsured dental and vision expenses ("health flexible spending account" or "health FSA"); (ii) contributions to a health savings account associated with a high deductible health plan; (iii) amounts for child and dependent care expenses ("dependent care assistance program" or "DCAP"); and (iv) adoption expense amounts. Each of the various component benefit programs made available under a cafeteria plan must meet its own often elaborate documentary requirements. Additionally, to maintain the favorable tax treatment afforded such benefits, the plan, including its component benefit programs, must periodically be updated for changes in applicable law.

For example, the Patient Protection and Affordable Care Act ("ACA") established, effective January 1, 2013, a

maximum amount of \$2,500 that can be contributed pursuant to an employee's salary deferral election to a health FSA in any year. Cafeteria plans that contain a health FSA component, therefore, must be amended to reflect this new limit or risk losing the tax benefits associated with the health FSA (and possibly those associated with other cafeteria plan benefits, as well), even if the \$2,500 limit is never exceeded. In a departure from usual procedure, which generally requires the adoption of a cafeteria plan amendment by no later than its effective date, the IRS has announced that employers may adopt retroactive amendments imposing the \$2,500 health FSA limit up until December 31, 2014.

## **Nondiscrimination Testing of Cafeteria Plans**

To the extent a cafeteria plan or a component benefit plan discriminates in favor of highly compensated or key employees, those employees will forfeit a portion, or in some cases all, of the tax benefits otherwise available to them under the arrangement. Plans are tested as to whether they discriminate in favor of highly compensated or key employees in any of the following three areas: (i) eligibility to participate; (ii) availability of benefits to participants; and (iii) actual utilization of benefits by participants. These concepts should be familiar to 401(k) plan sponsors, for whom offering plan participation to all employees and allowing everyone the same opportunity to defer compensation into their 401(k) plan accounts (thereby satisfying the eligibility and availability nondiscrimination tests) is no assurance that the plan is not discriminatory. If highly compensated employees defer on average at a substantially greater rate than the average for non-highly compensated employees, then the plan will fail the actual deferral percentage ("ADP") test, the nondiscrimination utilization test for 401(k) retirement plans.

The various nondiscrimination tests for cafeteria plans and their component benefit plans are exceedingly complex. Not only do the tests vary depending on the type of benefit program undergoing testing, this complexity is compounded by seemingly nonsensical definitional differences among the tests. For example, the DCAP testing rules look to an individual's compensation for the previous year in determining whether the individual is a highly compensated employee for purposes of current year testing. But testing for a health FSA is based on current year compensation. Further complicating matters, a plan may need to be tested across employee populations of different employers if there is sufficient commonality of ownership or a combination of joint ownership and common activity among them.

While under proposed regulations the nondiscrimination tests must be performed as of the last day of each plan year, it is generally advisable to also run the tests well in advance of such year-end to allow time to implement any necessary mid-year adjustments. In furtherance of this purpose, a cafeteria plan should specifically provide the plan administrator the authority to terminate an employee's salary reductions with respect to the plan and its component benefits to the extent necessary to comply with the nondiscrimination rules. Unlike in the 401(k) plan context, where an ADP testing failure can be corrected after the end of the plan year, once the cafeteria plan year is closed, it is too late to take corrective action.[www.barley.com](http://www.barley.com) 3

## **Nondiscrimination Safe Harbors**

Cafeteria plan testing usually requires specialized software and the involvement of an advisor experienced in its use and with the various tests. In certain limited contexts, however, testing can be largely avoided through an available "safe harbor" (much as nondiscrimination testing for a 401(k) plan can be avoided by adopting a safe harbor plan design). Proposed cafeteria plan regulations provide that if a POP's sole benefit is premium conversion for employer-provided health insurance, then so long as the arrangement satisfies an eligibility test, it will be deemed nondiscriminatory regardless of whether benefits are disproportionately utilized by highly compensated and key

employees.

The ACA provides a new safe harbor cafeteria plan for certain small employers, which mostly avoids the onerous testing required for cafeteria plans offering multiple component benefits. These "simple cafeteria plans" will be treated as satisfying the nondiscrimination rules for cafeteria plans and most component benefits (e.g., premium conversion, health FSAs and DCAPs, but not adoption assistance). Only employers with an average of 100 or fewer employees during either of the preceding two years can establish a simple cafeteria plan. Employees with at least 1,000 service hours during the preceding year must be eligible to participate, and the employer must contribute on behalf of all participants other than highly compensated and key employees, either 2% of the employee's annual compensation or a matching amount tied to the participant's salary deferral election, not to exceed 6% of compensation.

For questions concerning cafeteria plan documentation or for assistance with cafeteria plan nondiscrimination testing, please contact a member of our Employee Benefits Group.