

Section 125: Cafeteria Plan Common Questions

A Section 125 plan, or a cafeteria plan, allows employers to provide their employees with a choice between cash and certain qualified benefits without adverse tax consequences. Employees who participate in a cafeteria plan can pay for qualified benefits, such as group health insurance, on a pretax basis. This reduces both the employees' and the employer's tax liability.

Once an employee makes a cafeteria plan election, they may not change that election until the next plan year, unless the employee experiences a permitted election change event. This irrevocability requirement can be a disadvantage to participating in a cafeteria plan. Also, while the employer may reduce its tax liability by offering a cafeteria plan, it is responsible for the costs of establishing and maintaining the plan.

To receive the tax advantages associated with a cafeteria plan, the plan must generally pass certain tests that are designed to ensure that the plan does not discriminate in favor of highly compensated employees.

Links and Resources

- [Internal Revenue Code Section 125](#)
- IRS' [proposed Section 125 regulations](#) from 2007 – Taxpayers may rely on these regulations until final regulations are issued.

Examples of Qualified Benefits

- Medical plan coverage
- Dental and vision coverage
- Health FSAs
- Dependent care FSAs
- HSAs
- Life insurance coverage
- Disability benefits

Nondiscrimination Tests

In general, a cafeteria plan must satisfy the following three nondiscrimination tests:

- The eligibility to participate test;
- The benefits and contribution test; and
- The key employee concentration test.

Section 125 Basics

What is a Section 125 plan?

A Section 125 plan allows employees to purchase qualified benefits, such as health insurance, with pretax dollars. The rules in Section 125 of the Internal Revenue Code (Code) make this possible. A Section 125 plan is also commonly referred to as a cafeteria plan. The four basic forms of Section 125 plans are:

- Premium Only Plan
- Flexible Spending Account
- Full Cafeteria Plan
- Simple Cafeteria Plan

What is a premium only plan?

A premium only plan is the most basic—and most popular—type of Section 125 plan. A premium only plan, or POP, allows employees to pay their portion of insurance premiums with pretax dollars. Benefits that are typically offered within a premium only plan include health, dental, vision, accidental death and dismemberment, short- and long-term disability, and group-term life insurance on the life of the employee.

What is a flexible spending account?

Under Code Section 125, employees may make pretax contributions to a flexible spending account (FSA). An employee may seek reimbursement from the FSA for expenses paid for child care, health plan deductibles and eligible medical expenses not otherwise covered under a health plan. An FSA allows employees to increase their spendable income by allowing them to pay these expenses with pretax dollars.

There are three types of benefits that may be offered through an FSA:

1. Medical care reimbursement (that is, a health FSA);
2. Dependent care assistance; and
3. Adoption assistance.

FSAs are subject to the “use-it-or-lose-it” rule. Thus, any money remaining in the FSA at the end of the Section 125 plan year (or grace period, if applicable) is forfeited. However, the IRS has relaxed the use-or-lose rule for health FSAs. Under the relaxed rule, employers may allow participants to carry over up to \$660 (for plan years beginning in 2025, and adjusted for inflation each year) in unused funds into the next year. This modification applies only if the plan does not also incorporate a grace period.

What is dependent care assistance?

Dependent care assistance (dependent care FSA) allows an employee to set aside pretax dollars in order to pay for day care expenses. Expenses for food, education or medical care may not be reimbursed from a dependent care FSA. In order for dependent care expenses to be eligible for reimbursement, they must:

- Allow the employee or the employee's spouse to be gainfully employed or to attend school; and
- Ensure a qualified dependent's well-being and protection.

A qualified dependent is a child under the age of 13 or a spouse that is incapable of self-care.

There is a statutory limit on the amount of expenses that can be paid pretax under a dependent care FSA. The limit is calculated on a calendar-year basis and is equal to the smallest of the following amounts:

- \$5,000 (if the employee is married and filing a joint return or is a single parent);
- \$2,500 (if the employee is married but filing separately);
- The employee's earned income; or
- The spouse's earned income (if the employee is married at the end of the taxable year).

If a spouse is not gainfully employed because they are a full-time student or are incapable of self-care, then the spouse will be deemed to have an income of \$250 per month for one qualifying individual, or \$500 per month for two or more qualifying individuals.

The dependent care FSA is subject to the use-it-or-lose-it rule. Therefore, money remaining in the account at the end of the Section 125 plan year (or grace period, if applicable) is forfeited.

What is a health FSA?

A health FSA allows an employee to set aside pretax dollars in order to pay for eligible medical expenses not covered by insurance. Eligible medical expenses must be incurred:

- During the current health FSA plan year (or grace period, if applicable); and
- By the employee, employee's spouse or dependent.

Beginning in 2013, the Affordable Care Act (ACA) imposed a \$2,500 limit on salary reduction contributions to a health FSA. This limit applies on a plan year basis to grandfathered and non-grandfathered health FSAs, and is indexed for cost-of-living adjustments for 2014 and later years (for 2024 the limit is \$3,200, and for 2025 the limit is \$3,300). Employers may impose their own limits on employee health FSA contributions, as long as the employer's limit does not exceed ACA's maximum limit.

Health FSAs are subject to the use-it-or-lose-it rule. Therefore, money remaining in the account at the end of the plan year (or grace period, if applicable) is forfeited, subject to the IRS' relaxed rule for carryovers of up to \$660 (for plan years beginning in 2025; for plan years beginning in 2024, the carryover limit is \$640).

What is adoption assistance?

Adoption assistance allows an employee to set aside pretax dollars in order to pay for expenses incurred by the employee for qualified adoption expenses. Amounts paid by an employer (subject to dollar limits and other requirements) for qualified adoption expenses incurred in connection with the adoption (or, in certain cases, the attempted adoption) of a child are excludable from an employee's gross income if furnished pursuant to an adoption assistance program of the employer that meets the requirements of the Code.

Benefits under this type of program may be funded by the employer directly, by employees through salary reductions under a Section 125 cafeteria plan or by a combination of both methods. However, the irrevocable election and other requirements of Code Section 125 may detract from the appeal of offering adoption assistance benefits through a cafeteria plan.

What is a full cafeteria plan?

Under a full cafeteria plan, the employer makes a non-elective contribution for each eligible employee. Each employee may spend the employer contribution to purchase any of the benefits offered within the cafeteria plan. In addition, the employee may contribute pretax dollars to purchase additional benefits beyond what they can purchase with the employer's contributions.

What is a simple cafeteria plan?

Certain small employers' cafeteria plans may qualify as simple cafeteria plans, under which the applicable nondiscrimination requirements of a classic cafeteria plan are treated as satisfied. A plan qualifies as a simple cafeteria if it meets certain contribution, eligibility and participation requirements.

Eligibility and Participation

Who is eligible to participate in a Section 125 plan?

While there are some exceptions, generally, an employer can define which classes of employees and former employees are eligible to participate in a Section 125 plan. Some employers impose a waiting period before new employees are eligible to participate. In addition, some employers allow employees to participate in the Section 125 plan immediately, but impose a waiting period on participation on the FSA portion of the Section 125 plan.

The Section 125 rules specifically prohibit the following individuals from participating:

- Self-employed individuals;
- Partners within a partnership; and
- More than 2 percent shareholders in a subchapter S corporation (S corporation).

Self-employed individuals, partners and more than 2 percent shareholders in an S corporation (or their business entities) may sponsor a Section 125 plan for their employees. Under the ownership attribution rules of Internal Revenue Code (Code) Section 318, however, the spouse, children, parents and grandparents of a more than 2 percent shareholder cannot participate in the S corporation's Section 125 plan.

Can former employees elect COBRA and continue to participate in the Section 125 plan?

Generally, COBRA participants receiving severance pay may be permitted to continue to make pretax contributions toward the cost of insurance.

What are the advantages for employees to participate in a Section 125 plan?

Employees who participate in a Section 125 plan receive the following advantages:

- An employee realizes an increase in their spendable income by:
 - Paying their portion of insurance premiums with pretax dollars; and
 - Paying out-of-pocket medical expenses with pretax dollars set aside in an FSA.
- Where an employer offers a full cafeteria plan, an employee is provided an opportunity to elect only those benefits that they deem most valuable.

What disadvantages should an employee consider before electing to participate in a Section 125 plan?

Before an employee elects to participate in a Section 125 plan, they should be aware of the following disadvantages. First, an employee may not change their elections throughout the plan year unless they experience a permitted mid-year election change event (for example, the birth of a child or marriage). Also, while participation in a Section 125 plan reduces the employee's taxable income, it may also reduce other benefits. Benefits that are calculated using the employee's income (for example, Social Security or retirement benefits) will, in turn, be reduced.

Finally, any unused funds remaining in an FSA at the end of the plan year (or applicable grace period) are lost. There is a narrow exception to this "use-or-lose" rule for Section 125 plans that allow participants to carry over up to \$660 (for plan years beginning in 2025, and adjusted for inflation each year) in unused health FSA dollars to the next plan year.

Qualified Benefits

What benefits can be offered under a Section 125 plan?

Benefits that are typically offered under a Section 125 plan include:

- Health
- Dental
- Vision
- Accidental death and dismemberment
- Short- and long-term disability
- Group-term life insurance (up to \$50,000 in coverage)
- Health FSAs (to cover out-of-pocket medical expenses not covered by insurance)
- Dependent care FSA
- Health savings accounts (HSAs)

What benefits cannot be offered under a Section 125 plan?

The following benefits may not be offered under a Section 125 plan:

- Educational assistance plans
- Transportation fringe benefits
- Individual health insurance policies (major medical coverage)*
- Long-term care insurance or services
- Employer-provided meals and lodging
- Health reimbursement arrangements (HRAs)
- Dependent group-term life insurance

*Employers may offer an individual coverage HRA (ICHRA) to reimburse eligible employees' individual health insurance premiums. If an ICHRA does not cover employees' full premiums for individual coverage, the employer may permit employees to pay the balance of the premiums on a pre-tax basis through its Section 125 plan, provided the individual coverage is not purchased on an ACA Exchange. The Code prohibits employers from allowing employees to pay for Exchange coverage on a pre-tax basis.

Mid-year Election Changes

When can an employee change their elections under a Section 125 plan?

Participant elections under a Section 125 cafeteria plan must be made before the first day of the plan year or the date taxable benefits would currently be available, whichever comes first. Participant elections generally must be irrevocable until the beginning of the next plan year. This means that participants ordinarily cannot make changes to their cafeteria plan elections during a plan year.

Employers do not have to permit any exceptions to the election irrevocability rule for cafeteria plans. However, IRS regulations permit employers to design their cafeteria plans to allow employees to change their elections during the plan year, if certain conditions are met. For an employee to be eligible to change their cafeteria plan election during a plan year, the following general rules apply:

1. The employee must experience a mid-year election change event recognized by the IRS.
2. The cafeteria plan must permit mid-year election changes for that event.
3. The employee's requested change must be consistent with the mid-year election change event.

Also, employees' mid-year election changes must be effective prospectively. The one exception to this rule is for retroactive election changes that are permissible under the HIPAA special enrollment event for birth, adoption or placement for adoption.

Some of the IRS' mid-year election change events apply to all qualified benefits that can be offered under a cafeteria plan. However, other mid-year election change events only apply to certain qualified benefits—for example, not all of the IRS' mid-year election change events apply to elections for health FSAs.

A cafeteria plan may allow a participant to change their elections for qualified benefits upon the occurrence of any of the following events:

- Change in status (for example, employee's legal marital status, number of dependents, employment status, dependent eligibility change, change in residence or adoption proceedings);
- Significant cost changes;
- Significant curtailment of coverage;
- Change in coverage under other employer's plan;
- Addition or significant improvement of benefit package option;
- FMLA leaves of absence;
- Loss of group health coverage sponsored by a governmental or educational institution;
- COBRA qualifying events;
- HIPAA special enrollment events;
- Judgment, decree or court order, such as a Qualified Medical Child Support Order (QMCSO); and
- Medicare or Medicaid entitlement.

In [Notice 2014-55](#) and [Notice 2022-41](#), the IRS addressed cafeteria plan elections in specific situations related to the ACA and the availability of coverage through an Exchange. An employee may want to revoke an election under their employer's plan in order to purchase coverage through an Exchange in the following situations:

- **Reduction in hours** – The employee's hours of service are reduced so that the employee is expected to average less than 30 hours of service per week, but the reduction does not affect eligibility for coverage under the employer's group health plan.
- **Exchange enrollment** – The employee (or one or more related individuals) would like to cease coverage under the employer's group health plan and purchase coverage through an Exchange, without having a period of either duplicate coverage or no coverage.

In each of these situations, the IRS permits a cafeteria plan to allow an employee to prospectively revoke their election for coverage under the employer's group health plan during a period of coverage, as long as the plan is not a health FSA and the plan provides minimum essential coverage. Certain conditions must be met for the change to be permitted. Also, an election to revoke coverage on a retroactive basis is not allowed.

When can an employee change the amount contributed to their Section 125 dependent care FSA?

Under a Section 125 plan, participant elections generally must be irrevocable until the beginning of the next plan year. In some cases, a plan may permit a participant to make a mid-year change in election for their dependent care FSA. For example, a midyear election change is permitted when:

- A change in status event occurs, such as a change in the number of dependents;
- An increase in the cost of dependent care occurs, so long as the dependent care provider is not a relative of the employee;
or
- A change in status occurs that affects eligibility of dependent care expenses for tax exclusion (for example, an election may be modified where a dependent turns age 13 in the middle of the plan year).

Under this rule, it is also likely that some changes in employment status might allow a mid-year election change. For example, an employee taking a leave of absence or moving from full-time to part-time status would be permitted to change their election to correspond with the allowable tax exclusion.

When can an employee change the amount contributed to their health FSA?

A plan participant is permitted to make a mid-year change to their health FSA election following a change in status (for example, change in marital status, change in the number of dependents or change in employment status, such as termination or commencement of employment). A plan participant may also change their elections at the beginning and end of FMLA leave. In addition, the mid-year election change events for COBRA qualifying events, entitlement to Medicare or Medicaid, and judgements, decrees or orders (such as QMCSOs) also apply to health FSAs.

The IRS rules, however, do not allow plan participants to change their health FSA elections as a result of a change in cost or coverage. The expanded mid-year election change events for ACA reforms also do not apply to health FSA elections.

Can an employee change their elections when taking FMLA leave?

Yes. The commencement of FMLA leave is an event that allows an employee to revoke their existing Section 125 elections, including health and dependent care FSA elections. The employee's return from work following FMLA leave is also an event that allows an employee to modify their Section 125 elections, including health and dependent care FSA elections.

How are employee contributions made during FMLA leave?

While on FMLA leave, an employee may be permitted to pay their employee contributions on a pretax basis in one of three ways:

- Pre-pay the amount that would be owed during FMLA leave (provided the FMLA leave does not extend past the end of the Section 125 plan year);
- Pay the amount that is due each month while on FMLA leave (if receiving disability or vacation pay during leave); or
- Catch up on contributions upon return from leave.

If an employer significantly reduces coverage during the middle of the Section 125 plan year, can an employee change their elections?

Yes. If the employer significantly reduces coverage, affected plan participants may:

- Revoke their existing elections; and/or
- Elect another similar plan, if available.

As with most election changes, the change must be consistent with the event and be made effective going forward. (Note: The rules do NOT allow a mid-year election change to a health FSA in response to a significant reduction in coverage.)

If an employer adds or eliminates a benefit option during the middle of the Section 125 plan year, can an employee change their elections?

Yes. If an employer adds or eliminates a benefit option during the middle of the Section 125 plan year, affected plan participants may make a corresponding change in their elections. The change in election must be consistent with the event and be made effective going forward.

Under Section 125, can an employee make a mid-year election change that corresponds with elections a spouse made during their employer's open enrollment period?

Yes. An employee may make a mid-year election change that corresponds with elections a spouse made during their employer's open enrollment period. However, the change in election must be consistent with the elections made by the spouse and be made effective going forward. The rules do not permit a mid-year election change to a health FSA election.

Example: Employee works for Employer A. Employer A's Section 125 plan runs January through December. During the last open enrollment, employee waived medical and dental coverage. Employee's spouse works for Employer B. Employer B's Section 125 plan runs August through July. When first hired, the employee's spouse elected family coverage under the medical and dental plans. During the most recent open enrollment period, the spouse chose not to elect coverage under Employer B's plan. Employer A may allow its employee to elect family coverage under the medical and dental plans offered by Employer A.

Nondiscrimination Requirements

Do nondiscrimination rules apply to a Section 125 plan?

Section 125 plans must pass three complex nondiscrimination tests. In general, the tests are designed to determine whether the plan discriminates in favor of key employees or highly compensated individuals (HCIs). They are as follows:

- Eligibility to participate test;
- Benefits and contributions test; and
- Key employee concentration test.

Effective for plan years beginning after Dec. 31, 2010, the ACA allows certain small employers' cafeteria plans to qualify as simple cafeteria plans if they meet certain specific requirements relating to eligibility, participation and contributions. If these requirements are met, the applicable nondiscrimination requirements of a classic cafeteria plan are treated as satisfied.

A **highly compensated individual** generally includes any individual who is:

- An officer;
- A shareholder owning more than 5 percent of the voting power or value of all classes of stock of the employer;
- Highly compensated; or
- A spouse or dependent of a person described above.

An employee is considered "highly compensated" if they had compensation in excess of a specified dollar threshold for the preceding plan year, and, if elected by the employer, was also in the "top-paid group" of employees (that is, the top 20 percent).

What is the eligibility to participate test under Section 125?

A plan's eligibility rules may not discriminate in favor of HCIs. The eligibility test looks at whether a sufficient number of non-HCIs are eligible to participate in the cafeteria plan. If too many non-HCIs are ineligible to participate, the plan will fail this discrimination test. Under the eligibility test, a plan does not discriminate in favor of HCIs if it meets all of the following requirements:

Employment Requirement	The same employment requirement applies to all employees and the plan does not require more than three years of employment to participate.
Entry Requirement	Entry into the plan is not delayed.
Nondiscriminatory Classification Requirement	The plan benefits a classification of employees that does not discriminate in favor of HCIs.

The ACA prohibits group health plans from applying any waiting period that exceeds **90 days**. This ACA provision affects cafeteria plans because employers will generally want to allow employees to pay for their health plan coverage on a pretax basis, starting when they first become eligible for health plan coverage. Thus, employers will typically align their health plan's and cafeteria plan's waiting periods, which means that a cafeteria plan will rarely have a waiting period that exceeds 90 days.

What is the Section 125 benefits and contributions test?

A plan may not discriminate in favor of highly compensated participants as to benefits or contributions. This test is designed to make sure that a plan's contributions and benefits are available on a nondiscriminatory basis and that highly compensated participants do not select more nontaxable benefits than non-highly compensated participants.

Highly compensated participants are HCIs who actually participate in the plan.

A plan will pass or fail the benefits and contributions test based upon the facts and circumstances of each case. The factors the IRS considers when reviewing the facts and circumstances are:

- **Availability.** A plan must give each participant an equal opportunity to select nontaxable (qualified) benefits.

- **Utilization.** The IRS will review whether HCIs elected benefits to a greater extent than non-HCIs. For example, a plan would likely fail this test if benefits were so expensive that only HCIs could afford to elect the benefits.
- **Nondiscrimination in operation.** A plan may not discriminate in favor of HCIs in operation.

What is the Section 125 key employee concentration test?

Under a Section 125 plan, key employee contributions cannot exceed 25 percent of the total contributions into the plan. Only cafeteria plan participants who have elected one or more nontaxable benefits under the plan are included in the testing group. The test is performed by calculating the aggregate nontaxable benefits provided to key employees and the aggregate nontaxable benefits provided to all employees (key employees and non-key employees). Key employees must not receive more than 25 percent of the aggregate nontaxable benefits provided to all employees.

A **key employee** is generally an employee who is:

- An officer whose annual pay exceeds \$230,000 in 2025 (up from \$220,000 in 2024); or
- An employee who is either of the following:
 - A 5 percent (or greater) owner of the business; or
 - A 1 percent (or greater) owner whose annual pay is greater than \$150,000.

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