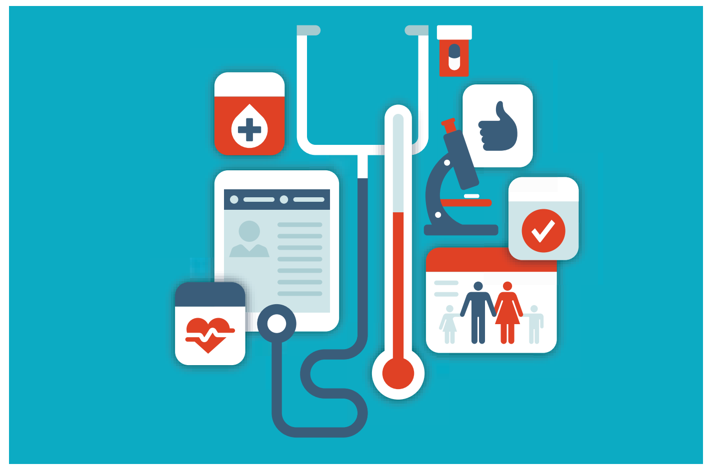
Is Code Section 125 Non-compliance Relative to Deductions for POP Plans Being Overlooked?

By Alison Polidano, CPA

American businesses face increasing burdens in this age of higher health insurance costs. As of 2015, 45.7 percent of private-sector businesses offered health insurance to their employees.[1] While in 2016 on average, companies paid in excess of $18,142[2] in health care coverage premiums for the employee and his/her family, and costs are rising. In fact, the *New York Times* has reported that "Health insurance companies around the country were seeking rate increases of 20 percent to 40 percent" in 2016.[3] Whether this increase was due to the Affordable Care Act (ACA) coverage mandates (which require capping individuals' out-of-pocket expenses), to the increase in medical costs in general, or to a combination of both, small businesses are especially affected. In addition, these small businesses could face penalties unless correct procedures for handling health care costs are followed (particularly employee contributions).

To help alleviate some of the expense of benefits, an emerging trend finds employees being asked to participate in the coverage of their health care premiums at a level nearing 40 percent of the total burden. In 2016, the average U.S. employee's personal annual contribution for premiums was $5,277, approximately 29 percent of the employer's cost.[4]



The Plan

When a small business decides to review options for employee participation in health care costs, its first step is generally to consult an insurance broker. The broker will usually recommend at a minimum that an employer wishing to pursue premium cost sharing with employees set up an IRC Section 125 Premium Only Plan (POP). To purchase insurance from most insurers, an employer is required to contribute at least half of the premium cost for each covered employee. The health insurance premium is the total amount an employer pays in advance to obtain coverage for employees under a particular level of service. It is usually billed monthly.

If the POP (also known as a cafeteria plan) is set up correctly, the employer may deduct each employee's portion of the premium payment from wages. Employers implement POPs to help employees save on federal, state and Social Security taxes, as well as to help themselves save on the employers' portions of FICA, FUTA and workers' compensation insurance premiums.

IRC Section 125 was created in November 1978, and sets forth requirements and tax treatments for cafeteria plans. Such plans allow employees to choose between receiving cash or taxable benefits for qualified benefits excluded from wages. Examples include insurance premiums and medical or dependent care expenses that are not covered by insurance.[5]

Businesses can draw on three main categories of cafeteria plans:

1. Premium Only Plans (POP);
2. Flexible Spending Accounts (FSAs), either a Health Care Spending Account (HCSA) or a Dependent Care Spending Account (DCSA); and
3. Cafeteria plans that use "credits or benefit bucks" referred to as either Consumer Driven Health Care (CDHC) or Defined Contribution plans.

If an employer implements a qualified cafeteria plan, a participating employee will approve an amount to be excluded from income as a "pre-tax" deduction.[6] Payroll then adds this as a "Section 125" or "pre-tax" deduction. Under Section 125 qualifications, small businesses that implement a simple cafeteria plan must pay a minimum percentage of the benefits, which by regulation rules is greater than 2 percent of employee compensation for the plan year. If an employer does not meet that qualification, the employer must pay either the lower of at least 6 percent of the employee's compensation for the plan year or twice the amount of the salary reduction contributions for simple cafeteria plans as outlined by the IRS.[7]

Simple cafeteria plans for small businesses allow any corporation, partnership, limited liability company (LLC), limited liability partnership (LLP), sole proprietor or nonprofit organization to implement a Section 125 plan if they had 100 or fewer employees on business days during either of the two preceding years.[8] However, prohibited from participating in POPs are individual members of an LLC or LLP, partners in a partnership, the owner of a sole proprietorship, or a shareholder of a Subchapter S corporation owning at least 2 percent of stock (including the spouse of the shareholder) since they are not defined as employees[9]. Also, employers who self-insure medical benefits for their employees may be ineligible.[10]

Administration

With regard to POPs in particular, the question arises of who is responsible for ensuring the employer has correctly implemented the plan and checked it for compliance with IRS and Department of Labor (DOL) guidelines. Generally, payroll companies do not question the Section 125 deduction when an employer requests adding it as a payroll deduction. Not all insurance companies offer a Section 125 plan. Insurance brokers are not responsible for setting up a POP. While insurance agents could possibly detect non-compliance, they rarely do.

Often, company owners and many CPAs or controllers are not up to date with IRC Section 125 requirements. In fact, an informal survey of small businesses and practicing CPAs in southeast Michigan revealed that those surveyed were unaware that a small business must set up a POP plan to take an IRC Section 125 deduction when their employees pay a portion of the health care premium. Many of those surveyed had been taking the deduction with no POP documentation in place.

Unlike HCSAs, which require Employee Retirement Income Security Act (ERISA) compliance, POPs require very little work to implement and maintain; essentially, a POP's one-time implementation includes the creation of a plan document and a plan description. There are also annual requirements. The first is to obtain each participating employee's signature on a salary reduction agreement stipulating that the employee has elected to participate. Second, one must conduct minimal year-end discrimination testing to ensure the plan does not favor key or highly compensated employees.

While not an ERISA plan, the contributions elected by employees to the POP medical plan are considered to be ERISA "plan assets." The DOL requires that these contributions be segregated from the employer's general fund within 90 days or earlier if the employer payroll system is able to segregate contributions more quickly. Once contributions become plan assets, employers are subject to ERISA fiduciary standards.

Sanctions

Both the DOL and IRS have oversight responsibilities over Section 125 compliance and small businesses that have not set up the system correctly may not be prepared in case the business is audited. In the absence of proper implementation and compliance, businesses and owners run the risk of sanctions. Thus, failure to comply with Section 125 rules could result in plan disqualification, in which case employee payroll deductions would be treated as taxable. Other consequences could include disallowing the company's tax-free treatment of the deductions back to the inception of the Section 125 deductions and assessment of back taxes with interest and/or penalties and DOL fines.

Implementation

An employer deciding to implement a POP that will ensure that employee deductions for premium sharing are tax-free should designate a plan sponsor/administrator. The administrator will have the sole

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responsibility of complying with all of the plan's administration, implementation, amendments, filings, reporting, disclosure and compliance requirements imposed by the plan, ERISA, the Internal Revenue Code (IRC) or any other applicable law.[11]

The administrator should follow these steps:

1. Create a formal plan document spelling out plan terms, election rules and administration procedures;
2. Review the plan with legal counsel and get board approval;
3. Distribute the plan description to all eligible employees;
4. Maintain annual summary election deduction forms, which spell out the maximum amount of elective contributions (the amount contributed to the plan through payroll deductions) available under the plan;
5. Set up Section 125 payroll tax deductions;
6. Complete annual discrimination testing; and
7. Maintain all forms in case of an IRS or DOL audit.

Employers may automatically enroll each employee as long as the employee has the option to opt out of coverage and receive taxable cash in lieu of the benefit.[12]

Affordable Care Act

The implementation of the ACA means health insurance is now offered through exchanges in most states. Due to this, IRS Notice 2013-54 prohibits any arrangements designed to fund the purchase of individual insurance policies through the exchanges or through the marketplace with pre-tax employee contributions via a cafeteria plan.[13] If the employer covers at least 50 percent of the health insurance premium, the ACA offers small businesses tax credits to help offset the cost of insurance. Starting in 2014, employees can waive employer coverage and find coverage on the exchanges. If the employee waives coverage due to the affordability test (i.e., costs exceed 9.5 percent of the employee's adjusted gross income), the employee will be eligible for tax breaks on the exchange.[4]

Enforcement

If, after implementing a Section 125 plan, the company fails to operate the plan in accordance with Section 125 rules, the result is an operational failure, the consequence of which could be to disallow the company's preferential tax treatment. Operational failures may include:

1. Offering benefits prohibited under the plan;
2. Operating to defer compensation; and
3. Allowing employees to revoke or make new elections that are not in accordance with the plan's rules.

Some reasons a company could be targeted for an audit include:

1. A participant complains about a possible violation under ERISA, COBRA, HIPPA or ACA law;
2. The IRS refers a case to the DOL; and
3. The DOL does a database search to identify "red flag" companies it feels are out of compliance.

IRS and DOL audits have ensnared some businesses. Usually the finding of a failure occurs during a payroll audit. In 2010, the DOL created a national enforcement project called the Contributory Plans Criminal Project (CPCP) designed to "target persons who commit fraud and abuse against participants and beneficiaries of contributory employee benefit plans."[15] In 2010, the DOL announced a joint initiative with the IRS to improve enforcement of workplace laws. Since the joint initiative's inception, the DOL has initiated 623 investigations, referred 424 investigations to prosecutors and obtained 141 indictments.[15] In 2012, the DOL's Employee Benefits Security Administration (EBSA) created the Health Benefits Security Project (HBSP), which is the comprehensive national health enforcement project. Some of the focus of the project is to examine plans for compliance with ERISA Part 7 and the ACA.[16]

While the main focus of these project investigations is on uncovering embezzlement of employee withholdings for health care benefits or for retirement benefit programs, assessment of Section 125 deductions could be included.

Recommendation

If you act in an advisory capacity to an employer regarding the administration of employee benefits, take the time to determine if adding a POP would benefit the employer. If the business already requires an employee to contribute a portion for health insurance premiums, review the current deductions with the payroll company. If the deduction is classified as a Section 125 deduction or a "pre-tax" deduction, the deduction is being treated as a pre-tax withdrawal from employee pay. If the business has been taking a Section 125 deduction without properly setting up a POP, ensure the business is aware of this deduction's ramifications. Review the current plans to determine if the company is in compliance with DOL and IRS regulations. Above all, insure compliance with all the current changes and administrative guidelines regarding the ACA and health care rules. ■

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