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D. Cost Changes With Automatic Increases/Decreases in Elective Contributions

A plan may be drafted to permit midyear election changes on account of a cost change with automatic increases/decreases in election contributions. Alternatively, a sponsor may design the plan to not allow election changes for this event, or only for certain aspects of the event.

This provision applies to elections for all qualified benefits other than health FSAs.⁶²

1. Regulatory Background

The regulations provide-

Automatic Changes. If the cost of a qualified benefits plan increases (or 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 increase (or decrease) in affected employees' elective contributions for the plan.⁶³

Several elements must be satisfied for this rule to apply: (a) the benefit at issue must be an eligible qualified benefit (i.e., not a health FSA); (b) the plan document should include language addressing increases/decreases in cost; (c) a determination must be made as to whether an increase or decrease is

significant (if the increase/decrease is not significant, then prospective election changes are automatic; if it is significant, then participants may be able to make an election change (see subsection E)); and (d) the plan sponsor must determine what portion of any cost increase should be passed on as participant contributions (e.g., all of it or just a pro rata share). These issues are discussed in this subsection D.

2. Automatic Election Language Must Be in the Plan

Under this provision, the plan must require the automatic election change in the event of an insignificant cost change. Thus, employees agree to future (and as of yet unknown) contribution changes that the employer deems insignificant, including cost-shifting changes imposed by the employer at its own initiative. Nothing seems to prohibit a plan sponsor from amending its plan to add such language, even midyear (e.g., upon an unanticipated rate increase), so long as the rule is applied uniformly and prospectively.

Sponsors should also include relevant language in the plan summary and employee election forms and should obtain pre-approval for future changes. Sponsors should also ensure that the pre-approval is consistent with applicable state wage withholding laws.

3. When Is a Cost Change Insignificant?

Unlike the significant cost-change event (discussed in subsection E), the automatic cost-change event does not use the word "insignificant." Yet many refer to this rule as the "insignificant" automatic changes rule. This limitation has been imposed by inference-if a change is significant, by definition the significant cost-change event "preempts the field" of available options for cost changes.

If the cost change is insignificant and the plan so provides, employee elections must automatically be changed. On the other hand, if a cost change is significant and the plan so provides, employees may have the choice to keep the existing coverage or make a new election for alternative coverage. See subsection E.

Unfortunately, the regulations provide little guidance as to when a cost change will be significant. An example relating to DCAP benefits indicates that, under the particular facts, a 12.5% change in the cost of care (from \$4,000 to \$4,500) may be significant.⁶⁴ However, IRS officials have cautioned that this should not be viewed as a safe harbor.

Consequently, plan sponsors will need to make the "significant vs. insignificant" determination based upon all the facts and circumstances,⁶⁵ including the dollar amount or percentage of cost increase. It is unclear what role (if any) affordability to participants may play. Presumably, a \$10 per month increase for minimum-wage employees is more significant than is a similar increase for highly paid professionals. Likewise, a \$10 per month increase may not be significant for major medical coverage, but it may be for vision or dental care. Employers should also look at past plan experience. For example, if most plan increases have been small percentages (e.g., 2% or 3%), then a 16% increase may be significant. While some degree of flexibility in determining significance under the rule is desirable, additional guidance from the IRS as to the factors to be considered would be helpful.

4. Employer-Initiated and Employee-Initiated Cost Changes Are Recognized

A permissible cost increase may be attributable to action by the employee (e.g., switching from full-time to part-time while remaining eligible for plan coverage) or action by the employer (e.g., a change in the amount of contributions required from employees). The regulations provide-

Application of cost changes. For purposes of [the change in cost provisions], a cost increase or decrease refers to an increase or decrease in the amount of the elective contributions under the cafeteria plan, whether that increase or decrease results from an action taken by the employee (such as switching between full-time and part-time status) or from an action taken by an employer (such as reducing the amount of employer contributions for a class of employees).⁶⁶

Examples of Cost Changes. Here are some examples of cost changes under the permitted election change regulations. Note that these examples do not address whether a particular increase is significant or insignificant (see the previous discussion), any potential discrimination issues, or any issues arising under other laws (e.g., COBRA).

Employee Initiated Act. Full-time employees are required to contribute 50% of the cost of dental coverage, while part-time employees must contribute 75% of the cost of such coverage. Mid-plan year, an employee switches from full- to part-time and the cost of her dental coverage increases. This is a cost increase under

the regulations, and Beta may increase the employee's contribution amount as a result of the change.

Employer Reduces Subsidy. Assume the same facts as above except that Beta decides to increase the full-time employees' share of the family dental coverage cost during the plan year. This is also a cost increase under the regulations. Beta apparently can raise the employee contribution rate even without a premium increase. Depending on the amount of the increase, the significant cost-change rules (see subsection E) may be triggered.

Employee Qualifies for State Premium Assistance Subsidy. An employee enrolled in Beta's major medical plan becomes eligible for a state premiums assistance subsidy from Medicaid or a state children's health insurance program (CHIP) under the plan. This is a cost decrease under the regulations, and Beta may decrease the employee's contribution amount as a result of the subsidy. Depending on the amount of the decrease, the significant cost-change rules (see subsection E) may be triggered.

Example: No Objective Reason for Change. Omega Co. makes health coverage available to its employees under a fully insured plan. The monthly premium for employee-only coverage is currently \$400 with employees contributing \$200; the premium for family coverage is \$800, with employees contributing \$400. Although Grover is married with children, he elects employee-only coverage for the cafeteria plan year. Midyear, he decides that he wants family coverage. No event has occurred other than Grover changing his mind. Grover argues that he can change his election to family coverage on the basis that the regulations permit salary reduction elections to be changed on account of employee-initiated action. The plan may permit Grover to change to family coverage, but he cannot pay the additional contribution on a pre-tax basis. The regulations refer only to a cost increase or decrease that "results from an action taken by the employee (such as switching between full-time and part-time status)," which seems to encompass only objective employee-initiated actions that automatically trigger cost changes in coverage and not an employee's subjective change of mind.

As noted above, the automatic cost-change provision will also apply to situations where employee costs change due to changes in their employment category-e.g., full-time to part-time-or due to qualification for specified employer wellness credits.⁶⁷ It may also be acceptable to pass on the cost changes and to automatically revise the employee's contribution amount when the employer's contribution increases or decreases each month based on the employee's work hours in the previous month.

5. Collectively Bargained Benefit Changes

Because collective bargaining may occur less frequently than annually, or because the contract year for a collective bargaining agreement may not correspond with a cafeteria plan year, benefit changes may arise midyear as a result of the bargaining process. The regulations clarify that the collective bargaining situation would be covered under the cost or coverage change rules, while underscoring that the rules do not apply to health FSA coverage.⁶⁸ In one example, union negotiations during the cafeteria plan year reduce indemnity coverage premiums and office visit copayments, and add a new HMO option. Under the circumstances, health FSA elections cannot be changed, even though the coverage change would allow employees to switch to the HMO option or remain in the indemnity option with decreased contributions and copayments.⁶⁹ Thus, for example, health FSA elections could not be reduced even though employees who switched options might have more comprehensive health coverage, leading to reduced health FSA expenses.

6. Does the Automatic Cost-Change Rule Apply to DCAPs?

Although the cost or coverage change events generally apply to DCAPs, the regulations do not address the application of the automatic cost-change rule to DCAPs. IRS officials have informally commented that the rule does not apply to dependent care provider cost changes, although a DCAP election change could be made based on a provider cost change if the change is significant.⁷⁰ (See subsection E for a discussion of the significant cost-change event.) Perhaps the thinking behind these comments was that DCAP costs are not set by the employer and, under a literal application of the rule, cannot be automatically adjusted for changes in the way that health coverage costs can. In any event, this interpretation seems to be at odds with the IRS's practical application of the regulations to DCAPs to allow election changes based on cost or coverage changes. (See subsections E, F, and G.) Presumably, most plan sponsors and administrators will interpret this rule as allowing automatic increases and decreases of DCAP elections when the employer is notified that a cost change has occurred, so long as the plan's terms require such changes (and the provider is not a relative-see subsection E).

7. Application to Automatic Benefit Increases or Decreases

Many plan sponsors allow automatic election changes in certain situations involving factors beyond an employee's control. For example, plans that base group term life or disability insurance coverage upon

compensation may automatically increase or decrease the level of coverage (and corresponding elections) upon a change in compensation level. Arguably, under such arrangements, the employee's "election" doesn't change when the coverage automatically increases or decreases. See subsection T. In any event, such changes would likely fall under the automatic cost-change rule.⁷¹

8. Component Plan Year Differs From Cafeteria Plan Year

In some cases, the plan year for a component plan (e.g., a health insurance plan) is different than the plan year for the cafeteria plan. (We recommend trying to avoid such misalignment, as it causes inevitable midyear election change problems, especially with regard to health FSA benefits; see Section XVI.)

Example: Different Policy and Plan Years. Tools for Tomorrow, Inc. has a July 1 to June 30 major medical plan year, but a January 1 to December 31 cafeteria plan year. During the December open enrollment period for the cafeteria plan, employees elect health insurance coverage (and perhaps health FSA and DCAP coverage too) and agree to pay their share of the cost of coverage with pre-tax dollars. Major medical insurance premiums increase by 3% effective with the new major medical plan year on the following July 1. Can employees' salary reductions be increased then, considering that July 1 is in the middle of the calendar cafeteria plan year?

The automatic cost-change event is well-suited for this situation. If, under 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 increase in affected employees' salary reductions for major medical plan coverage.

Employers that anticipate wanting to use the automatic cost-change event should include it in their cafeteria plan documents. The plan documents, SPD, and enrollment forms should also indicate that the contributions employees must pay are subject to change from time to time, and that if the employees' contributions (as set by the employer) increase or decrease effective as of any other time during the cafeteria plan year, then employees will be required to make a corresponding change in their payments. These documents should also clarify that no changes in health FSA or other benefit elections can be made as a result of the cost increase.

9. Admitting New Participants Due to Insignificant Cost Decrease Is

Prohibited

The insignificant cost-change rule does not apply to individuals who waived coverage because the cost was too high. This is because the rule must apply automatically, and it therefore cannot be applied to non-participants. But see subsection E for a discussion of significant cost decreases.

10. Automatic Cost Changes Matrix-Some Election Changes a Plan May Permit (Not Exhaustive)

The following matrix reflects some (but not all) of the election changes that are consistent with a cost changes with an automatic increase/decrease in election contributions. *Caution:* This matrix is only a partial summary of our views. Consult the rest of this subsection D and the detailed regulations when evaluating a change.

Event	Major medical	Dental and Vision	Health FSA	DCAP	Employee Group Term Life, AD&D, and Disability Coverage
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Cost Changes With Automatic Increase/Decrease in Elective Contributions (including employer-motivated changes and changes in employee contribution rates) *	Plan may automatically increase or decrease (on a reasonable and consistent basis) affected employees' elective contributions under the plan, so long as the terms of the plan require employees to make such corresponding changes.	Same as previous column.	No change permitted. [†]	Application is unclear. [‡] Presumably, plan may automatically increase or decrease (on a reasonable and consistent basis) affected employees' elective contributions under the plan, so long as the terms of the plan require employees to make such corresponding changes.	Same as major medical column.
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* Treas. Reg. § 1.125-4(f)(2)(i).

† Treas. Reg. §1.125-4(f).

‡ See subsection D.6.

⁶² Treas. Reg. §1.125-4(f)(1).

⁶³ Treas. Reg. §1.125-4(f)(2)(i).

⁶⁴ Treas. Reg. §1.125-4(f)(6), Example 7.

⁶⁵ Informal, nonbinding remarks of Harry Beker and Christine Keller, IRS, Office of Chief Counsel, Feb. 28, 2001 ECFC Teleconference.

⁶⁶ Treas. Reg. §1.125-4(f)(2)(iii).

⁶⁷ Informal, nonbinding remarks of Christine Keller and Janet Laufer, IRS, Office of Chief Counsel, June 5, 2000 ECFC Teleconference.

⁶⁸ Treas. Reg. §1.125-4(f)(6), Example 1.

⁶⁹ See Treas. Reg. §1.125-4(c)(4), Example 1(iii) and Example 5(ii). In contrast, note that the change in status rules will sometimes permit an increase or decrease in health FSA coverage if the consistency requirements are met. See subsection C.

⁷⁰ Informal, nonbinding remarks of Christine Keller and Janet Laufer, IRS, Office of Chief Counsel, June 5, 2000 ECFC Teleconference.

⁷¹ Informal, nonbinding remarks of Harry Beker and Christine Keller, IRS, Office of Chief Counsel, Aug. 4, 2000 ECFC Annual Symposium.

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