When can an election to a cafeteria plan be applied retroactively?

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A Section 125 plan, commonly referred to as a cafeteria plan, provides employees with the option of purchasing employer-sponsored benefits on a pre-tax basis. These plans allow employees to pick between increased total compensation and contributing part of their compensation for the payment of benefit premiums. Employees that choose to contribute part of their salary to premiums can do so by making an election. These elections are generally irrevocable during the plan year and a new election cannot be made until the next annual open enrollment period. The IRS does permit plan sponsors to design their cafeteria plans to permit employees to make some mid-year change elections after the occurrence of certain events and HIPAA requires group health plans to allow several other mid-year changes.

The cafeteria plan rules only permit elections to be effective prospectively with two exceptions. An employer can design their cafeteria plan to allow elections for new hires to be applied retroactively as long as the election is made within 30 days of their hire date. The IRS has given this exception to the general rule because the IRS acknowledges that onboarding of a new employee does not always happen day 1 on the job. This exception is optional for employers and would only apply to employers that have immediate eligibility or a waiting period less than 30 days. It does not apply to plans that have longer waiting periods, terminated employees that were rehired within 30 days, employees returning from unpaid absence, or "newly eligible" individuals due to a change in eligibility (e.g., an employee moving from benefits ineligible to benefits eligible).

The other allowable retroactive change is when an employee has a HIPAA special enrollment right due to birth, adoption, or placement for adoption. HIPAA mandates that all group health plans permit this mid-year change, but whether an employer permits the premiums election to be changed is optional (although almost all cafeteria plans are designed to allow this mid-year change). In order for the changed premiums to be made on a pre-tax basis, the election must be made within 30 days from the date of the acquisition, and the change is retroactive to the date of the birth, adoption, or placement for adoption.

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We frequently find that employers are not properly handling the mid-year elections. Employers have the option to permit other mid-year changes to be retroactive, but cannot permit the retroactive premiums to be paid on a pre-tax basis.   If an employer allows retroactive changes for other reasons, the retroactive premium should either be waived or the employee should have to pay their portion on an after-tax basis.

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