



COMPLIANCE OVERVIEW

Tips on Correcting Cafeteria Plan Administration Errors



A Section 125 plan, or a cafeteria plan, allows employees to pay for certain benefits on a pre-tax basis. To receive these tax advantages, a cafeteria plan must comply with the rules of Internal Revenue Code Section 125 and IRS regulations.

In general, cafeteria plans that fail to operate according to their written plan terms or that otherwise fail to operate in compliance with Section 125 and the regulations **will not be considered** cafeteria plans, which means employees' elections between taxable and nontaxable benefits will result in **gross income to the employees**. Errors affecting component benefit plans may also violate other federal group health plan laws, such as ERISA or COBRA.

Section 125 and the accompanying regulations do not address how to correct cafeteria plan administration mistakes. However, this Compliance Overview highlights best practices for plan sponsors to consider to help guide effective and compliant correction efforts.

Tips on Correcting Cafeteria Plan Administration Errors

As a starting point, the best way to avoid cafeteria plan administration mistakes is to understand how and why errors typically occur—and to take proactive steps to prevent them from occurring in the first place. Many plan sponsors conduct voluntary compliance reviews of their benefit plans to identify and address potential issues before they arise. To support these efforts, the following sections outline common administrative mistakes, recommended best practices, and key considerations for effective error correction and prevention.

Common Mistakes

Many plan administration issues stem from miscommunication, operational issues or unfamiliarity with Section 125 and its accompanying regulations, with the errors outlined below being among the most common.

Improper mid-year election changes without a qualifying event

In most cases, an employee cannot change their elections under a cafeteria plan during the period of coverage (usually the plan year). However, the IRS allows employers to design their cafeteria plans to allow employees to change their elections during the plan year only if specific conditions are met:

1. The employee experiences a mid-year election change event recognized by the IRS;
2. The cafeteria plan explicitly allows mid-year election changes for that event in its written plan document; and
3. The employee's requested change is consistent with the mid-year election change event (e.g., adding a dependent after birth).

A common mistake occurs when employers, as plan sponsors, permit mid-year election changes without verifying that all three conditions are satisfied. For example, an employee may experience a qualifying event, such as marriage, that is recognized by the IRS. While it may be appropriate for the employee to change from employee-only to family coverage in response to that event, the plan must also specifically allow such a change (Condition 2). If the plan document does not permit mid-year changes for marriage, the election would be invalid. Additionally, even if the plan allows changes due to marriage, the employee cannot use that event to discontinue contributions to group term life insurance, since that change is unrelated to the nature of the qualifying event (Condition 3).

Another important consideration for employers is that some of the IRS' mid-year election change events apply to all qualified benefits that can be offered under a cafeteria plan, while others are limited to specific benefits. For example, not all of the IRS' mid-year election change events apply to elections for health flexible spending accounts (FSAs). Thus, it is important to carefully review which events apply to each benefit and ensure that the cafeteria plan document clearly outlines the permitted changes.

Incorrect salary reduction withholdings

Cafeteria plans are primarily funded through salary reduction agreements between employers and employees, where employees agree to have a portion of their salary withheld on a pre-tax basis to pay for qualified benefits such as health insurance. These elections must generally be made on a prospective basis, typically during an annual open enrollment period, with the elections taking effect on the first day of the upcoming plan year. Employees who become eligible for benefits during a plan year (for example, new hires) will usually make their elections during an initial enrollment period.

Mistakes can occur when salary reduction amounts are either miscalculated or applied retroactively, often due to administrative oversight. If the amount withheld does not match the employee's authorized election, resulting in either too much or too little salary being withheld, the plan will fall out of compliance with Section 125.

Offering or reimbursing non-qualified benefits under the plan

Cafeteria plans may offer a variety of qualified benefits, such as accident and health benefits, adoption assistance, dependent care assistance, and dental or vision benefits. However, benefits that are not recognized as qualified under Section 125 cannot be offered under a cafeteria plan, such as Archer medical savings accounts, long-term care insurance, or employer-provided meals and lodging. If a plan offers non-qualified benefits, it risks losing its status as a cafeteria plan, which means employees' elections would become taxable.

Enrollment mistakes

Eligibility errors in cafeteria plan administration can occur when individuals who do not meet the criteria under Section 125 are mistakenly allowed to participate, or when eligible individuals are inadvertently excluded from plan participation. These issues often occur during open enrollment, when large volumes of elections are processed, and can lead to discrepancies in salary reduction amounts and errors in the administration of component benefit payments. When correcting these issues, it is important for employers to assess whether, and how, adjustments should be made across the various benefits offered under the plan.

Failing to comply with applicable nondiscrimination rules

To receive favorable tax treatment, cafeteria plans must generally pass a series of nondiscrimination tests designed to ensure that the plan does not disproportionately benefit highly compensated employees. If a cafeteria plan fails these tests, highly compensated employees lose the tax benefits of participating in the plan and must include the benefits or compensation in their income. However, non-highly compensated employees will not lose the tax benefits of participating in the plan even if the plan fails nondiscrimination testing. Nondiscrimination testing should be performed each plan year; if performed early, employers will have time to make any necessary adjustments to maintain compliance. Because nondiscrimination testing is complex, most employers use outside service providers to perform it. It's also important to keep in mind that additional nondiscrimination tests apply to specific benefits that may be offered under a cafeteria plan, such as health and dependent care FSAs.

Key Details to Assess

When a plan administration error is discovered, employers should conduct a thorough assessment to ensure corrective actions are appropriate. The following factors are critical to guiding that process:

- **How and why the mistake occurred** (e.g., poor documentation, inadequate training, or other operational gaps)—Identifying the underlying cause helps inform both the correction strategy and future prevention efforts.
- **When the mistake occurred** (e.g., before or during the plan year, or over the course of multiple plan years)—The timing may affect the scope of correction, the tax implications, and whether retroactive adjustments are possible.
- **How many participants or beneficiaries are affected by the mistake**—If the mistake is isolated, a simpler fix may be needed, whereas a systemic issue impacting a large group may necessitate broader corrective action and consultation with legal or tax advisors.
- **Duration of corrective measures**—Employers should assess how long it will take to implement necessary corrective measures and whether it involves coordination across multiple departments or systems. Understanding the timeline and complexity helps minimize operational disruption and ensures that corrective actions are carried out efficiently.
- **Whether other entities (such as a third-party administrator) were involved in the mistake**—If other parties played a role in the error, employers should coordinate closely with them to ensure that responsibilities are clearly defined and

future errors are prevented through improved collaboration and oversight.

Best Practices

In the absence of formal guidance on how to fix cafeteria plan administration problems, the following best practices and considerations can help guide effective and compliant correction efforts:

- **Gather as much information as possible when a mistake is discovered to guide the correction process**, such as documentation regarding plan elections, payroll records, open enrollment communications and plan documents.
- **Use reasonable best efforts to correct any problem**. Employers should act in good faith to resolve the issue and restore plan integrity. Consultation with benefits counsel or other knowledgeable benefits experts can help ensure that corrections are handled appropriately.
- **Take steps to restore the plan and affected individuals to a position they would have been in had the mistake(s) never occurred**. This may involve adjusting salary reductions or correcting benefit elections where appropriate.
- **Apply corrections consistently and uniformly**. When resolving cafeteria plan errors, it is essential to use the same correction methods for all similarly situated employees to ensure fairness and compliance.
- **Make corrections that are reasonable and proportionate to the error**. Tailor the correction to the nature and impact of the mistake.
- **Establish and implement preventive measures to minimize the risk of future recurrences**. Employers may need to take proactive steps to strengthen their internal processes to maintain compliance and reduce the likelihood of repeated mistakes. This may include enhancing enrollment procedures, conducting voluntary self-audits, and reviewing plan documents regularly to ensure compliance. When designing these preventive measures, employers should consider working with benefits counsel to ensure all safeguards align with regulatory requirements.

Employer Takeaway

Resolving cafeteria plan administration errors involves many factors and can present significant compliance risks. Due to limited formal guidance from regulatory agencies in this area, employers who discover such errors should promptly consult with benefits counsel or their plan advisors to determine the most appropriate corrective strategy. Conducting a thorough evaluation of the cause of the error, the scope of the error and the impact of the error not only facilitates effective resolution, but also strengthens the overall integrity of the plan and reduces the likelihood of future noncompliance.

LINKS AND RESOURCES

- [Internal Revenue Code Section 125](#)
- IRS' [proposed Section 125 regulations](#) from 2007 (taxpayers may rely on these until final regulations are issued)
- [IRS Publication 15-B](#), "Employer's Tax Guide to Fringe Benefits" (provides an overview of cafeteria plan requirements)
- [IRS Memorandum No. 201413006](#) (regarding correction procedures for improper health flexible spending arrangement payments)

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