

IRC Section 125

Note: This section only applies to state agencies and higher-education institutions.

Section 125 of the Internal Revenue Service code allows the employer to deduct money from the employee's paycheck before certain payroll taxes and income taxes are calculated. This rule allows for deductions including monthly premiums for medical coverage and for the state's medical Flexible Spending Account (FSA), and for the state's Dependent Care Assistance Program (DCAP).

If employees have questions on how this will affect their future social security benefits, they should contact the Social Security Administration and request an estimate.

For further information, refer to the Employee Enrollment Guide "Questions and Answers" section, "Premiums Paid with Pre-Tax Dollars". The Section 125 Waiver form is available for download.

Subscribers may change their IRC Section 125 status during annual open enrollment or if a qualifying event triggers a special open enrollment. *Note: See the Special Open Enrollment section of this manual*

Section 125 State of Washington Payroll Rules

Payroll information questions and answers:

1. How will an employee on paid annual or medical leave be handled under the Section 125 plan?

Payroll contributions for staff on annual or medical leave will be treated no differently than for other active employees.

2. How will employees who are on LWOP be treated?

Employees who self-pay for coverage while on leave status will be covered under the employer coverage upon the date of return. The employee contribution will begin the first of the month in which the employee returns to work. The employee will be reimbursed any self-pay premium paid for that month.

3. How will premium deductions for employees on FMLA be handled?

Employees may prepay to employers, but prepayment should not cross plan years. Employer contributions will continue up to the first 12 weeks of approved family leave. Employees must also continue to pay the employee premium contribution to maintain eligibility. The Health Care Authority will not be able to track prepayment on an employee-by-employee basis. Arrangements for prepayment will be made between the employer's payroll office and the employee. The HCA's eligibility system will not reflect the arrangement.

4. What will be the effective date of transfers between employers?

The employer losing an employee will use an effective date of the last day of the month in which the transfer occurred. The losing agency is responsible for the employer contribution for the entire month. The gaining agency will use the first of the month following the transfer.

5. How will the higher-education institutions handle employee premium deductions for summer coverage?

The method used will be driven by the employer. The payroll contribution system will be that

used for FMLA.

6. **How will employees who are on industrial insurance active claims be treated for payroll contributions and Section 125?**

Implementation of payroll contributions will have no impact on the rules for eligibility for those on workers compensation coverage.

7. **Will we need to track whether people are Section 125 or not on the insurance system?**

Our intention is to track these people only on payroll systems. This means that when the HCA's insurance system creates payroll contribution levels for payroll systems, it will not be able to indicate which of these payroll contributions are for non-Section 125 contributions.

8. **What are the rules for when an employee can change Section 125 status, and how will the employee make the change?**

An employee can only change his or her Section 125 status during annual open enrollment each year, unless there is a qualifying event that triggers a special open enrollment. PEBB may also remove an employee from the Section 125 deduction, with notice, when it is necessary to prevent excess tax deferral.

9. **Will Section 125 benefits affect deferred compensation allowable maximums?**

Maximum allowable deferred compensation levels for certain employees at the lower end of compensation levels may be reduced under various pre-tax deferral programs such as Sections 457 and 403B.

Personal checks considered taxed employee contributions

Even though an employee chooses the pre-tax option for health insurance payroll deductions, if the employee is not on an active payroll (which can sustain the pre-tax deductions), personal check payments will be treated as taxed employee contributions.

Examples of this include:

- An employee remains on pay status while on leave, using eight hours of paid leave per month to retain benefits. If the employee's pay does not cover the pre-tax insurance deduction, the employee needs to send a personal check to maintain the insurance. This personal check will be considered an after-tax employee contribution.
- An employee is on the employer's payroll for nine months (for example, faculty), and the employee authorizes pre-tax premiums to be collected in advance by payroll deduction for the summer months. (Note: Prepayment of health coverage by payroll deduction cannot cross the plan year.) However, the payroll office forgets to take the deductions in error. In this case, when the employee sends a personal check to pay for his or her coverage, adjustments should be made in the payroll system to convert the personal check to pre-tax status.

De minimis default policy for terminated employees

When a pre-tax health insurance payroll deduction has been improperly taken from a terminated employee who is no longer on an agency's payroll, this deduction should be refunded at the deduction gross amount. For example: A pre-tax deduction of \$16 may only actually cost the employee \$10.30 after saving income tax, OASI, and Medicare. Agencies may refund the entire \$16 and not change the pre-tax federal reporting already completed. Refund this amount from the account that retains health insurance deductions until paid to the HCA.

The administrative costs to make extensive corrections and complete changes for federal depositing and reporting outweigh the very minimal future benefits for employees and lost tax

revenue to IRS. It is estimated these incidents will be rare now that payroll, personnel, and benefits offices are familiar with the new procedures. This policy has been reviewed by the IRS and is in compliance with Section 125.

FMLA premium payment options and tax treatments

In conjunction with IRS proposed regulations, three payment options may be offered under a Section 125 to an employee who chooses to continue group health coverage while on unpaid FMLA leave. These are pre-pay, pay-as-you-go, and catch-up. We recommend only the first two options be used. The catch-up option would involve the employer paying for the employee's share of premiums until the employee returned from leave.

- **Pre-pay:** This option allows the employee to pay the insurance premiums due during the FMLA leave in advance. These may be made on a pre-tax or after-tax basis, depending on the employee's Section 125 status for the plan year. No pre-tax advance payments may be made for any time period in the next plan year (plan year runs January - December), nor may an employer require an employee pre-pay for the leave period.
- **Pay-as-you-go:** Under this option, employees may make his or her premium payments on the same schedule as if (s)he were not on leave or by the date premiums are due to the HCA. These contributions are made on an after-tax basis unless they are taken from any taxable compensation paid the employee during the leave period.

Delinquent payment of FMLA employee contributions

During FMLA leave, employee contributions are due to the employer on the first calendar day of the month of coverage. If the payment has not been received by the 15th of that month, the personnel, payroll, or benefits office must send a delinquency notice to the employee. This notice shall state that unless payment is received by the final day of the month, insurance coverage will be terminated on the final day of the month of coverage, retroactive to the first day of the month for which payment has not been received. If payment has not been received by the final day of the month, the coverage should be terminated and a letter sent to the employee confirming that termination.

Reporting on Section 125 participation

Individual payroll systems are responsible for submitting information to the HCA on an annual basis which will comprise form 5500, Annual Return/Report of Employee Benefit Plan to the Internal Revenue Service (IRS). **The HCA will compile information from all payroll systems to submit on form 5500 report to the IRS.**

Your agency's information will be submitted on an input form supplied by the HCA. It will summarize data for those employees whose Section 125 payroll contributions are processed through each respective payroll system. The HCA input form will require the following information:

- Number of total employees
- Number of employees eligible to participate in the plan
- Number who actually participated
- Total cost of the fringe benefit plan (total payroll contributions qualifying under the plan)

Forms and instructions for input will be distributed by the HCA to payroll system offices by October 31 of each plan year. Copies of the completed input forms from each payroll office will be due to the HCA by January 31 for the prior calendar (plan) year.

Paying for your health premiums with pre-tax dollars

Your health premiums are paid with pre-tax dollars

Internal Revenue Service code Section 125 allows your employer to deduct money from your paycheck before certain payroll taxes and your income tax are calculated. This rule allows for deductions, including:

- Monthly premiums for your medical coverage, and
- The state's dependent care program.

Why should I pay my monthly health premiums with pre-tax dollars?

While the difference is not very noticeable, you take home more money because taxes are calculated *after* the premium is deducted. By paying for your coverage this way, you reduce your taxable income, which lowers your taxes and saves you money.

Do I need to sign up for a Section 125 deduction?

No. Your personnel, payroll, or benefits office does this automatically unless you sign the section 125 waiver form, saying you do **not** want your health premiums deducted from your paycheck before taxes.

Can I change my mind about participating in a Section 125 deduction?

Yes, but on a limited basis. You can only change your Section 125 choice:

- During annual open enrollment, and
- When there is a change in family status, such as marriage, establishment, or termination of a qualified domestic partnership, divorce, addition of a new child, or removal of a child from your coverage who has reached the maximum age limit.

Your employer may also remove you from the section 125 plan, with notice, if necessary to prevent excess tax deferral.

When would it benefit me *not* to have a Section 125 deduction?

If you have your deductions taken on a pre-tax basis under Section 125, it lowers your salary base used to calculate these benefits:

Social security – The section 125 plan reduces your social security salary base (if your base is under the 87,900 maximum), so you are saving money now by not fully paying social security taxes. If you are near retirement age and have your health premiums deducted pre-tax, your lifetime social security benefit would be calculated using the lower salary.

Unemployment Compensation – The Section 125 also reduces your salary base used to calculate unemployment compensation.

To waive your Section 125 option, complete the waiver form and submit it to your agency's personnel, payroll, or benefits office.

Where can I get more information about Section 125?

For advice on your individual situation, you should talk to a qualified financial planner or your local Social Security office.