F. Special Issues for Adoption Assistance Offered Under a Cafeteria Plan

Adoption assistance benefits are among the benefits that can be offered on a pre-tax basis through a cafeteria plan (provided the plan document is drafted to permit it). Employers with a limited budget for adoption assistance may wish to offer employees the opportunity to make pre-tax salary reductions or to apply employer flex credits (if any are provided) toward adoption assistance benefits through a cafeteria plan—also referred to as an adoption assistance FSA. However, the irrevocable election and other requirements of Code §125, and the lack of FICA savings, may detract from the appeal of offering adoption assistance benefits through a cafeteria plan. Establishing an adoption assistance FSA under a cafeteria plan would cause the FSA rules to apply (other than the uniform coverage rule applicable only to health FSAs). This includes, for example, the “use-or-lose” rule that will cause adoption assistance contributions to be forfeited if not used to pay expenses incurred during the plan year (or during the grace period, if applicable).

1. Tax Consequences Are Generally the Same as for Employer-Funded Programs

An adoption assistance FSA offered under a cafeteria plan generally produces the same tax consequences as a stand-alone employer-provided adoption assistance program, in that—

- subject to the dollar and income limits and to other requirements of Code §137, adoption assistance amounts paid under a cafeteria plan may be excludable from an employee’s income, and an employee receiving adoption assistance must affirmatively claim the income exclusion by filing IRS Form 8839 with the employee’s income tax return;
- adoption assistance amounts paid under a cafeteria plan are not subject to federal income tax withholding and are therefore not reported as wages in box 1 of IRS Form W-2 (however, such amounts must be reported in boxes 3, 5, and 12 of IRS Form W-2, as explained in subsection E); and
- while not considered wages for income tax withholding purposes, adoption assistance amounts reimbursed under a cafeteria plan are considered to be wages subject to federal Social Security and Medicare taxes (FICA), federal unemployment taxes (FUTA), and railroad retirement tax (RRTA) withholding.

Does Lack of Employment Tax Savings Make Adoption Assistance Less Attractive? Avoiding employment tax liability (particularly FICA) for certain benefits (e.g., health FSA and DCAP benefits) is sometimes cited as an incentive for employers to offer such benefits under a cafeteria plan, and the savings may tend to offset the administrative costs of maintaining the cafeteria plan. With no savings on FICA, FUTA, or RRTA, offering
adoption assistance under a cafeteria plan may be less attractive to employers.

2. Adoption Assistance Must Be Added to Cafeteria Plan Document as Available Benefit

A cafeteria plan must provide a specific description of each of the benefits available under the plan. If an adoption assistance FSA will be offered through a cafeteria plan, it must first be added to the benefits described in the cafeteria plan document. The description of available benefits need not be self-contained; therefore, the cafeteria plan may incorporate by reference benefits established under a separate written adoption assistance program. Note that when an adoption assistance FSA is offered as a qualified benefit under the employer's cafeteria plan, an adoption assistance program can satisfy the written plan requirement of Code §137 either through a separate document that is not part of the written cafeteria plan document or as part of a written cafeteria plan document.

a. Uniform Coverage Rule Does Not Apply: Benefits May Be Limited to Amounts Contributed to Date

The uniform coverage rule is applicable only to health FSAs and does not apply to adoption assistance FSAs (just as it does not apply to DCAPs). Thus, reimbursements available under an adoption assistance FSA through a cafeteria plan can be limited to the amount that has been contributed to the plan at the time reimbursement is requested.

b. Period of Coverage and Grace Periods

Subject to the ability to provide a 2-1/2 month grace period, discussed below, a cafeteria plan may only pay or reimburse expenses incurred during a plan year (a 12-month period) from that year's contributions or benefits. The period of coverage for an adoption assistance FSA under a cafeteria plan would therefore be 12 months.

c. Expenses Must Be Incurred During Coverage Period

Under the proposed cafeteria plan regulations, FSA expenses cannot be reimbursed until the expenses have been “incurred”—which means that the services must actually be rendered. The fact that a participant has been billed for or has paid an expense generally is not enough to satisfy the “incurred” requirement.

d. Limit on Health FSA Salary Reductions Not Applicable

The limit that applies to salary reduction contributions to a health FSA ($2,650 for 2018; $2,700 for 2019) does not apply to contributions for other cafeteria plan benefits. Thus, the limit does not extend to salary reductions for an adoption assistance FSA.
3. Salary Reduction Elections for Adoption Assistance

In general, the rules for salary reduction elections under a cafeteria plan apply to salary reductions for adoption assistance just as they do for other benefits elected under a cafeteria plan. In particular, elections must be voluntary, prospective (i.e., made before the salary that employees would otherwise receive is made available to them), and irrevocable during the plan year. (The possibility that elections could be changed upon the occurrence of certain election change events is discussed in the following text box.)

Are Employment Taxes Paid Upon Salary Reduction or Upon Reimbursement? Like 401(k) contributions (but unlike health FSA or DCAP benefits), adoption assistance benefits are subject to the FICA, FUTA, and RRTA employment taxes even when offered through a cafeteria plan. It is well-settled that employee deferrals under a 401(k) plan are subject to withholding for these taxes at the time of salary reduction. It is unclear, however, when these employment taxes must be withheld from adoption assistance benefits—at the time of salary reduction or at the time reimbursements are paid from the adoption assistance reimbursement account? This is because adoption assistance benefits under a cafeteria plan are subject to forfeiture at the end of the plan year (unlike employee deferrals under a 401(k) plan), and forfeited amounts are not subject to employment taxes. Generally, under principles of constructive receipt, amounts are not taxed so long as there is a risk of the participant forfeiting the benefit. Therefore, in the absence of specific guidance on the issue, employers might choose to wait until the time a reimbursement is processed to withhold the employee's share of the applicable employment taxes and pay the employer's share. Employers doing so may need to adjust their payroll and employment tax reporting systems to be sure these amounts are appropriately processed and included in year-end W-2 reporting. The other alternative would be to withhold the applicable employment taxes upon salary reduction and then request a refund of any overpayment of employment taxes at the time of a forfeiture. Employers may wish to consult with tax counsel on this issue and review which method is most compatible with their payroll and employment tax reporting systems.

4. Employer Contributions (Other Than Salary Reductions)

An employer offering an adoption assistance FSA through a cafeteria plan may, in addition to allowing pre-tax salary reductions, make other contributions available for adoption assistance benefits, such as employer flex credits or seed or matching contributions. Employers that want to make contributions toward adoption assistance benefits may prefer, however, to offer an employer-provided adoption assistance program outside of a cafeteria plan. There, an employer can design the program to give employees flexibility to request reimbursements in the year their expenses occur.
without the need to predict which year that will be. Employers also have the flexibility to design the program to reimburse expenses only after an adoption becomes final, regardless of when the expenses were incurred, without being restricted by cafeteria plan rules that limit reimbursements to expenses incurred during the coverage period.

5. Issues Created by the Use-or-Lose Rule

As noted above, and subject to the ability to provide a 2-1/2 month grace period, discussed below, a cafeteria plan may only pay or reimburse expenses incurred during a plan year (a 12-month period) from that year’s contributions or benefits. Accordingly, unused amounts remaining in a participant’s adoption assistance FSA may not be carried over to pay or reimburse expenses incurred in a subsequent plan year and are required to be forfeited.

a. Rule May Be Especially Treacherous for Adoption Assistance Participants

Even though predicting the timing of adoption expenses can be difficult, employees who choose to pay for such expenses under their employer’s cafeteria plan must make their best guess about when expenses will be incurred. It may be possible to organize required services (fees for placement evaluations, adoption agency fees, certain attorneys’ fees, etc.) to ensure that they are incurred in the required cafeteria plan year. But other expenses, especially those associated with finalization of an adoption (e.g., travel expenses to bring a foreign-born child home) may be more difficult to predict. Employees electing adoption assistance benefits through a cafeteria plan for expected adoption assistance expenses should discuss the anticipated timing of such expenses with their advisors (adoption agencies, attorneys, etc.).

b. Availability of 2-1/2 Month Grace Period May Be Especially Important for Adoption Assistance Plan Participants

Cafeteria plans may provide a grace period of up to 2-1/2 months immediately following the end of each plan year during which unused benefits or contributions remaining at the end of the plan year may be paid or reimbursed to plan participants for qualified benefit expenses incurred during the grace period. In other words, the cafeteria plan document may permit participants to submit eligible expenses incurred during the grace period, to be paid or reimbursed from unused amounts remaining at the end of the immediately preceding plan year. Given the unpredictability of certain adoption expenses, the availability of a grace period may be especially appealing to participants electing adoption assistance benefits through a cafeteria plan.

c. Ability to Receive Benefits in Years Before Adoptions Are Finalized Will Also Be Especially Important for Adoption Assistance Plan Participants

It is not uncommon for employer-provided adoption assistance programs offered outside a cafeteria plan to provide no benefits until an adoption is finalized. (Among other things, this avoids the need to explain the somewhat complicated timing rules that apply
to the income exclusion for certain adoptions and the need to distinguish between domestic and foreign adoptions.) To include such a rule in an adoption assistance program funded through a cafeteria plan, however, would only increase the likelihood of forfeitures. (This is because plan participants would be required not only to predict the timing of expenses but also the finalization of the adoptions and make sure those events fall within the applicable cafeteria plan year or grace period.) Cafeteria plans with adoption assistance FSAs should therefore allow plan reimbursements in the year in which qualified adoption expenses are incurred, leaving the participant to sort out when the income exclusion for such reimbursements may be claimed.

Example: Adoption Expenses May Be Reimbursed in a Year Before They Can Be Excluded From Income. Josie participates in her employer's calendar-year cafeteria plan, under which adoption assistance benefits are offered. Before the 2018 plan year begins, Josie elects to make $2,400 in pre-tax salary reductions for adoption assistance benefits under the cafeteria plan. In December 2018, she submits, and the plan reimburses, a claim of $2,400 for qualified adoption expenses that Josie incurred for services provided in 2018 in connection with a foreign adoption. The adoption becomes final in 2019. Josie and her spouse have a combined modified gross income in 2019 of $211,160 or less, and thus the income limitation does not apply. Josie is required to include the $2,400 reimbursement in her gross income for 2018, because foreign adoption expense reimbursements are not excludable before the year in which the adoption is finalized. But Josie is entitled to exclude $2,400 (the reimbursement received in 2018) from gross income for the 2019 tax year (the year the adoption becomes final) by making an appropriate adjustment to her 2019 Form 1040.† In 2018, Josie may need to make an adjustment to her income tax withholding (on Form W-4) or make estimated tax payments to avoid potential penalties for underpayment of tax, since the $2,400 reimbursement was taxable to her in 2018.†

† IRS Notice 97-9, II.G.2, 1997-2 I.R.B. 35. See also Instructions to IRS Form 8839.

The above discussion makes clear the need for communication to employees about the possible impacts of the use-or-lose rule. Employees should be warned about the possibility of forfeiting adoption assistance amounts in their adoption assistance FSAs and should be advised to carefully estimate the amount and timing of expected expenses. This should be part of the larger process of determining, with the aid of tax advisors as needed, how to coordinate the tax credit and the income exclusion to maximize tax savings. The forfeiture of even a portion of salary reductions, for example, can effectively eliminate the net effect of tax savings under the tax credit or income exclusion.

In addition, employers should consider contacting employees throughout the course of the year to let them know what their account balance is, to remind them that they should be submitting reimbursement requests on a timely basis, and to explain what election change events may be available (see the discussion below).
Amounts forfeited under a cafeteria plan's adoption assistance FSA are subject to the FSA experience gain rules (also sometimes referred to as the forfeiture rules) under proposed cafeteria plan regulations. Like DCAPs, which are also subject to these FSA rules, adoption assistance programs are not ERISA plans and therefore these programs are not subject to ERISA's plan asset rules. Accordingly, use of an adoption assistance FSA's experience gains is subject only to limitations of the Code and any applicable state law. Proposed regulations under Code §125 indicate that experience gains may be retained by the employer or used by the employer to defray expenses of administering the cafeteria plan. The experience gains may also, on a reasonable and uniform basis, (1) be used to reduce required salary reduction amounts for the immediately following plan year; or (2) be returned to employees. The proposed regulations, however, prohibit an allocation based on the amount of forfeitures experienced by a particular participant. Whatever alternative is ultimately chosen, it should be documented in the adoption assistance program document and communicated to participants. Because adoption assistance programs are not covered by ERISA, state laws (e.g., escheat laws) must also be taken into account, particularly if the plan is funded (i.e., the monies are held in separate accounts for participants) as opposed to unfunded (where amounts remain in the employer's general assets).

6. Which Election Change Events Apply to Adoption Assistance?

Given the potentially painful effects that the use-or-lose rule may have for some cafeteria plan participants, it will be particularly important for plan sponsors to permit as many election change events as possible. The election change events most likely to be applicable are discussed below; others may apply in particular circumstances. As with all of the election changes permitted under IRS regulations, the election change must be done on a prospective basis. As a result, adoption assistance FSA participants must be vigilant about monitoring the progress of their adoptions in order to predict possible changed circumstances that might support an election change, because participants will lose unused amounts under the use-or-lose rule.

Incorporating Election Change Events Into the Cafeteria Plan Document. The election change events described in the IRS regulations are not automatically available to plan participants; rather, applicable election change events must be incorporated into the plan document. Given the limited number of events that apply to adoption assistance elections, it is particularly important that the plan document's description be tailored to the plan—the drafting technique of incorporation by reference is particularly ill-suited to adoption assistance programs.

a. Election Change Event for Commencement or Termination of Adoption Proceedings

The only election change event expressly applicable to adoption assistance benefits is the change in status event that permits a change in election for “commencement or termination of an adoption proceeding.” Inclusion of this election change rule will help
ameliorate the effects of the use-or-lose rule if an adoption assistance FSA is offered under a cafeteria plan. Specifically, it will allow a participant who has elected more in cafeteria plan salary reductions than he or she may actually have contributed at the time adoption proceedings are terminated to eliminate future salary reductions, but it will not permit a participant to recoup amounts that were already taken out of his or her salary. It will also permit a participant who has made no salary reduction elections for adoption assistance to begin contributing salary reduction amounts midyear after adoption proceedings commence.

The other change in status events under Treas. Reg. §1.125-4(c) (change in employee's legal marital status; change in number of dependents; change in employment status; dependent satisfies (or ceases to satisfy) dependent eligibility requirements; change in residence) do not appear to apply to adoption assistance FSA elections, except to the extent that they indirectly cause a termination of an adoption proceeding (for example, because the adopting couple divorce or give birth to another child). Nevertheless, any such change would not permit a participant to recoup salary reduction amounts that were already taken out of his or her salary.

b. Unclear Whether Election Change Event for Significant Cost Changes Might Apply

A plan may be drafted to permit a participant to change elections midyear on account of a significant cost change. This provision applies to elections for benefit package options other than health FSAs. Specifically, the final regulations provide:

**Significant Cost Changes.** If the cost charged to an employee for a benefit package option (as defined in paragraph (i)(2) of this section) significantly increases or significantly decreases during a period of coverage, the cafeteria plan may permit the employee to make a corresponding change in election under the cafeteria plan. Changes that may be made include commencing participation in the cafeteria plan for the option with a decrease in cost, or, in the case of an increase in cost, revoking an election for that coverage and, in lieu thereof, either receiving on a prospective basis coverage under another benefit package option providing similar coverage or dropping coverage if no other benefit package providing similar coverage is available.

This election change event has been applied liberally in the context of dependent care assistance plan elections. But it is unclear how, if included in the cafeteria plan document, this election change rule would apply in the context of adoption assistance reimbursement account elections. Coverage costs and DCAP expenses are typically monthly or periodic charges, which can change on an ongoing basis (for example a major medical plan premium may significantly increase at the start of its plan year, or a day-care provider's monthly charge may significantly decrease when a child starts half-day kindergarten). It is unclear whether certain changes in adoption expenses (such as a mistaken cost estimate, the addition of an unanticipated cost, or a change in the process that eliminates an otherwise expected charge) could constitute a significant
change in cost or coverage under this election change event. But it is likely that this
election change event could apply, for example, in a situation where an employer
subsidy for adoption assistance is significantly increased or decreased midyear.

c. Election Change Event for Change in Coverage Under Other Employer Plan
Might Apply

The election change event for changes in coverage under another employer's plan
might also permit prospective election changes regarding adoption assistance (e.g., in
circumstances where a plan of the employee's spouse adds or eliminates adoption
assistance benefits), provided the change is consistent and satisfies the other generally
applicable rules for election changes.

d. Events Not in the Regulations That May Permit Election Changes for Adoption
Assistance

As for other benefits offered under a cafeteria plan, certain events not in the regulations
may permit midyear election changes. These include, as relevant for adoption
assistance FSAs, mistakes by the employer or employee (subject to the relatively strict
IRS rules for what constitutes a mistake) and election changes needed to pass
nondiscrimination tests or to maintain qualified program status.

Code §125(f):

For purposes of this section, the term “qualified benefit” means any benefit which, with
the application of subsection (a), is not includible in the gross income of the employee
by reason of an express provision of this chapter (other than section 106(b) [medical
savings accounts], 117 [qualified scholarships], 127 [educational assistance programs],
or 132 [fringe benefit programs]).

Adoption assistance benefits are not includible in an employee's gross income by
reason of an express provision of chapter 1 of the Code (i.e., Code §137). See also
qualified benefit that can be offered under a cafeteria plan).

Under Prop. Treas. Reg. §1.125-5(a), a flexible spending arrangement (FSA) is a
benefit program that provides employees with coverage under which (a) specific,
incurred expenses may be reimbursed (subject to reimbursement maximums and other
reasonable conditions); and (b) the maximum amount of reimbursement reasonably
available to a participant is not substantially in excess of the total salary reduction and
employer flex credit for the participant's coverage (that is, the maximum amount of
reimbursement must be less than 500% of the total of the salary reduction and
employer flex credit). For purposes of this rule, an employer flex credit is a nonelective
employer contribution that the employer makes for every employee eligible to participate
in the employer's cafeteria plan, to be used at the employee's election only for one or
more qualified benefits, but not as cash or for taxable benefits. Adoption assistance funded through a cafeteria plan generally will satisfy this rule.


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