

## Cafeteria Plans

A Cafeteria Plan (or flex spending account) is another name commonly used to refer to Section 125 of the Internal Revenue Code. This newsletter will explain the basic features of a Cafeteria plan and why it may be of interest to you as a business owner. Cafeteria plans have the potential to be a cost-effective way that employers can provide employees a pre-tax benefit with the employee participating in the costs through the use of salary reduction



### **What is a Cafeteria plan and what are its advantages?**

A Cafeteria plan is a type of welfare benefit plan specifically authorized by Section 125 of the Internal Revenue Code. It is a way to provide employees with valuable benefits. Under this type of plan both the employee and employer can potentially have significant tax savings. Instead of offering an after tax payroll **deduction** to employees, the employer could offer a pre-tax payroll **reduction** in the amount of the employee's share of the benefits cost. The money that was reduced is not taxed to the employee. These reduced monies are then held in an account maintained for the employee by the employer to be later used for "qualifying benefits" by the employee. These reimbursements also have the benefit of escaping federal, state, and social security taxation.

The key advantage of a Cafeteria plan from an employer's standpoint is that they save money as well. This is because the money that has been reduced from the participating employees compensation is not subject to payroll taxes. Also insurance premiums may be reduced for coverage's like workers compensation and disability insurance if those are based on your employees' taxable salaries. Perhaps of equal benefit is the goodwill generated by providing this tax saving program to employees.

### **Who can adopt a Cafeteria plan?**

Basically anyone can add a Cafeteria Plan to the company's benefits and it does not require any change in already established fringe benefits.

### **What are the requirements for a Cafeteria Plan?**

The principal requirements to qualify under Section 125 are to adopt a written plan document, all participants must be employees, contributions must be made through a salary reduction agreement, and the plan must meet the nondiscrimination, election and enrollment requirements specified under the Code.

### **What types of options exist in Cafeteria plan?**

An employer can make their Cafeteria plan as simple or complex as they wish. Here are three different options that exist and the employer may choose to offer any or all of the three options.

- On the most simple level is the Premium Offset Plan (POP). This plan is for the health care insurance premiums that are being paid by the employee for their group health care benefits. The payment is removed from their paycheck on a pre-tax basis. These amounts are then used to pay the premiums to the health insurance carrier.

- Next is the Flexible Spending Account (FSA). This allows employees to set aside some of their wages on a pre-tax basis to pay for expenses not covered by their company's health plan. Some examples include deductibles, non-prescription drugs, eyeglasses, etc. The employee chooses the amount to be set aside into the FSA, if they wish to participate, on an annual basis and this amount is then divided among the pay periods for the plan year. The employee must realize that any money that is not used by the end of the plan year is lost and goes to the company. This is what the IRS calls a "Use it or Lose it" provision. Employers can designate maximums or restrictions of what this money can be used for if they choose to prevent the loss from potentially occurring to their employees. Also careful planning by the employee can help limit any loss if they fully understand how the plan works.

- Finally the Dependent Care Account (DCA) is another option. The money in this account can only be used for dependent care expenses. Unlike the FSA, only money that has already been deducted from the employee can be reimbursed by the company to the employee. This means there is little risk of loss to the employer.

### **How do Cafeteria plans work?**

Basically a Cafeteria plan allows employees to make salary reductions on a pre-tax basis to an account maintained by the employer. Each participant prior to the start of the plan year decides the amount of the salary reductions. These amounts can only be changed during the plan year if a "Qualifying or Life Event" as specified by the IRS occurs to the participant. These reductions are placed each pay period into a separate spending account for each benefit elected by the employee. Then, as each employee incurs a qualifying expense, he or she submits a claim to the plan administrator, who processes the claim and reimburses the employee from the money in the plan. Funds do not need to be specifically segregated and earmarked for the plan, but accounts are generally set up to track the amount set aside and used by each employee.

### **What are the limits on how much I can put into the Cafeteria Plan?**

Employee reductions can be any amount. The only IRS restriction is that the amount cannot exceed the employee's annual salary. The only exception to this is the case of a dependent care account that cannot exceed \$5,000 per year. Also there is a general non-discrimination requirement that does state that "Key Employees" can receive no more than 25% of the total plans reimbursements.

### Who is a Key Employee?

A Key Employee is an individual who owns more than 5% of the company, an officer earning more than \$130,000, or any employee and any family member of such an employee who owns 1% or more and earns more than \$150,000.

### Who is not eligible to participate in a Cafeteria plan?

Partners in a partnership, sole proprietors and owners who own 2% or more of a Subchapter S Corporation cannot participate in a cafeteria plan, although they may sponsor a plan for their employees

### Who is eligible to participate in a Cafeteria plan?

Generally when the plan is created the employer can choose the eligibility restrictions they want all employees to meet prior to being able to participate in such a plan. These may include age, years of service or hours worked annually. In addition, certain Non-Discrimination rules apply to insure the Section 125 plan does not unfairly discriminate against certain classes of employees.

### What is the "Period of Coverage"?

The period of coverage for a Cafeteria plan is 12 months. Every year the company must give all eligible employees a new set of enrollment forms that must be completed prior to the start of the new plan year. It is at this time employees can change their elections for the next twelve-month period.

### What are the advantages to employees?

Employees are more likely to accept the idea of having to pay for a portion of their own benefits if it increases their total benefits and lowers their taxes. Also they will take home more

money each pay period and have better and/or more benefits available to them from their employers.

### What is the disadvantage to Employees?

Basically the only disadvantage to the employee is the chance that they will not spend all of the money in their account prior to year-end resulting in their money being lost. Although, if this is carefully explained and employees are aware they can get balance information at any time during the year, it is unlikely that they will end up losing anything by the end of the plan year.

### What is the advantage to the Employer?

Offering such a plan may help you both attract and then maintain good employees within your company. Also the tax advantages from the money employees contribute to the plan not being subject to FICA, FUTA, and SUTA tax for the employer is an obvious benefit. These tax savings could potentially offset the cost of maintaining such a plan.

### What is the disadvantage to the Employer?

The biggest risk for employers is that in an FSA the total amount chosen by the employee for the year must be available from the very first day of the plan. This means if the employee uses the total amount prior to the end of the year and then terminates employment before year end, the employee may have been reimbursed by the employer for more than they had had contributed from their income up to the point of termination. If this occurs then the employer may have to absorb the loss. Also the employer would have to fund the plan if the money was not already in the plan when the claim was submitted. There are ways to limit this type of loss depending on the setup of the enrollment forms.

### Show me the numbers!

*This example shows you the difference between having no plan, a POP, or having a POP, FSA, and a Dependent Care Plan.*

	<u>CURRENT</u>	<u>PREMIUM ONLY</u>	<u>PREMIUM, FSA &amp; DEPENDENT CARE</u>
<u>EMPLOYEE:</u> John Doe			
Gross Income	\$25,000	\$25,000	\$25,000
<u>Cafeteria Reduction</u>			
Health Premium	\$ 0	\$ 1,440	\$ 1,440
Non-reimbursed Medical Expenses	\$ 0	\$ 0	\$ 900
Dependent Care	\$ 0	\$ 0	\$ 4,000
<b>Taxable Income</b>	<b>\$25,000</b>	<b>\$23,560</b>	<b>\$18,660</b>
<u>Taxes</u>			
Federal Income (18%)	\$ 4,500	\$ 4,241	\$ 3,359
State Income (5%)	\$ 1,250	\$ 1,178	\$ 933
FICA (7.65%)	\$ 1,913	\$ 1,802	\$ 1,427
<b>Total Taxes</b>	<b>\$ 7,663</b>	<b>\$ 7,221</b>	<b>\$ 5,719</b>
<b>Net Pay Before Deductions</b>	<b>\$17,337</b>	<b>\$16,339</b>	<b>\$12,941</b>
<u>Payroll Deductions</u>			
Health Premium	\$ 1,440	\$ 0	\$ 0
Non-reimbursed Medical Expenses	\$ 900	\$ 900	\$ 0
Dependent Care	\$ 4,000	\$ 4,000	\$ 0
<b>Total Deductions</b>	<b>\$ 6,340</b>	<b>\$ 4,900</b>	<b>\$ 0</b>
<b>Take Home Pay</b>	<b>\$10,997</b>	<b>\$11,439</b>	<b>\$12,941</b>
<b>Employee Savings</b>	N/A	<b>\$ 442</b>	<b>\$ 1,944</b>
<b>Employer Savings</b>	<b>\$ 0</b>	<b>\$ 111</b>	<b>\$ 486</b>