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SIMPLE Cafeteria Plan

Under the Healthcare Reform package, effective January 1st, 2011 small employers can now adopt new SIMPLE Cafeteria Plans. Under the law, SIMPLE Cafeteria Plans are required to meet nondiscrimination requirement as long as the employee of the plan meets certain eligibility, participation, and minimum contribution requirements. This "safe harbor" would also cover the non-discrimination requirements mandated for employers when it comes to certain benefits like group life insurance, coverage under a self-insured group health plan, and benefits under a dependent care assistance program.

What is a Cafeteria Plan?

A Cafeteria Plan (as provided for under Internal Revenue Code Section 125) is an employer sponsored plan under which employees have the option of selecting benefits or cash. Employees can choose which tax free benefits fit their needs, or may instead elect to receive taxable cash payments in lieu of unselected benefits. For example, under a Cafeteria Plan, employees may use salary reduction to pay their share of premiums for health insurance provided by their employer, with these payments made on a pre-tax basis. Thus, **a Cafeteria Plan provides tax savings to employee and employer alike** by subtracting premiums from gross salary before federal income and Social Security taxes are calculated.

Who qualifies for a SIMPLE Cafeteria Plan?

A small employer is defined as one with an average of 100 or fewer employees on business days during either of the two preceding years. If the employer was not in existence during the prior year, the determination is based on the average number of employees who are reasonably expected to be employed on business days during the current year.

Once the plan is established, the company will be deemed to meet the requirement even if it grows to employ more than 100 people in subsequent years; this window has been established to encourage employers to continue hiring. Finally, once employees number 200 or more, the business no longer qualifies for a SIMPLE Cafeteria Plan.

How does it work?

A SIMPLE Cafeteria Plan allows employees to use pretax funds to pay their portion of the health, vision, dental, and other employer-sponsored welfare premiums. The employer contribution must (a) equal a uniform percentage (not less than 2 percent) of the employee's compensation for the plan year, or (b) equal a 200% match of the employee contributions up to 6% of the employee's compensation for the plan year. The rate of match for highly compensated employees cannot exceed the rate of match for non-highly compensated employees.

Who is an eligible employee?

In order to meet nondiscrimination requirements, all non-excludable employees with at least 1,000 hours of service during the preceding plan year must be eligible to participate in a SIMPLE Cafeteria Plan.

An employer may elect to exclude employees who have not attained age 21 before the end of the plan year, have less than one year of service as of any day during the plan year, are covered under a collective bargaining agreement, or are nonresident aliens.

A plan may provide for a shorter period of service requirement for employees who are younger, if desired. Each eligible employee must be able to elect any benefit available under the plan under the same terms and conditions as those applied to all other participants.

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Who can benefit?

If an employer offers the SIMPLE Cafeteria Plan, the plan is deemed to pass discrimination testing. In discrimination testing, highly paid executives and other key employees' (as defined by regulations) benefits in the plan are compared to benefits provided to other employees who are contributing to the plan. If the plan does not pass certain threshold tests and therefore fails the test, benefits are refunded as necessary to the highly compensated employees and become taxable to them.

For companies with a greater number of higher-level employees, such as a physicians' practice or a law firm, making the commitment to a SIMPLE Cafeteria Plan can allow key employees and executives to maximize their benefits by freeing them from discrimination testing.

Another incentive to employers is the savings on payroll taxes. In addition, because the IRS may provide its own checklist in order to implement these plans, employers will save on plan document costs as well.

These plans require that employers make a minimum employer contribution, which means putting more dollars into the plan. By allowing endorsers to avoid the potential discrimination testing issues, this slight drawback to the plan may be worth the investment.

Who can not benefit?

An excellent benefits delivery tool, a SIMPLE Cafeteria Plan helps employers provide tax free benefits to employees. Unfortunately, the Healthcare Reform legislation did not change current law, in which sole proprietors, members of limited liability companies (LLCs), partners in a partnership, and more than two percent shareholders of S corporations are precluded from participating in a Cafeteria Plan. These restrictions will continue to be a major impediment to small business use of Cafeteria Plans.

What changes have occurred in Flexible Spending Accounts?

Nonprescription, over-the-counter drugs now require a doctor's prescription if they are to be eligible for reimbursement in an FSA (or in a Health Savings Account or Health Reimbursement Arrangement). Further, the employer is responsible for compliance with these rules, which includes maintaining adequate records.

Beginning in 2013, the maximum reimbursement amount is limited to $2,500 for FSAs as part of a Section 125 plan. Previously, there was no Internal Revenue Service (IRS) limit on the amount that employees could defer on a pretax basis into a Flexible Spending Account. Meanwhile, companies on average imposed a $5,000 limit, generally because the employer can become responsible for paying this amount.

For example: employee opts to defer $5,000, in January employee undergoes surgery and uses the funds; the employer must provide the funds, even though said funds have not been taken from the employee's paycheck yet. This scenario illustrates the problem which can arise when an employer reimburses an employee who then leaves the company before funds can be collected through payroll contribution. By imposing a $2,500 cap, the plan generates the after-tax revenue while also presenting an opportunity for a cost savings to the employer and limiting exposure.

Can the plan discriminate in offering benefits?

A Cafeteria Plan may not discriminate in favor of highly compensated participants and it may not favor key employees. In the past, the non-discrimination rules have discouraged small business owners from using Cafeteria Plans, because, if the non-discrimination rules are violated, the plan benefits provided to highly compensated or key employees must be taxed. The prior potential for taxation of benefits resulted in small employers being less likely to provide Cafeteria Plans to their employees.

The SIMPLE Cafeteria Plan not only eases the administrative burden once faced by small businesses that sponsored a Cafeteria Plan, but the Healthcare Reform package also provides a safe harbor to the discrimination requirements applicable to highly compensated and key employees.

Before deciding whether a SIMPLE Cafeteria Plan is right for you, consider all of the options available to business owners and the advantages and disadvantages of each type of plan.

Davis & Hodgdon Associates entrepreneurial advisory services include assistance in selecting the plans best-suited for small businesses. This is just one in a unique brand of services focused squarely on the needs of growing businesses. For more information call 802-878-1963.

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