Cafeteria Plans
Or
§125 Plans
Or
Flexible Spending Accounts (FSAs)

(All refer to an IRS approved plan for paying certain bills on a pre-tax basis)

Here is some information about the tax advantages of a cafeteria plan for your employees and for a description of the different types of cafeteria plans available. What follows is a description of the basic nature of such plans, the tax advantages that they can provide, and the types of plans available.

Overview. Cafeteria plans may be the most attractive way of providing certain benefits to employees. Each employee may choose between receiving cash and receiving one or more qualified benefits offered on a "menu." Thus, workers may match benefits to their own needs and priorities. A plan can be as simple or as complex as the employer wants, ranging from a plan that allows only salary deferrals to pay the employee portion of health insurance, to one offering an extensive menu of benefits.

Types of Plans. A cafeteria plan allows employees to reduce their salaries and to use the forgone amount to purchase, on a pre-tax basis, benefits not fully subsidized by the employer. Thus, as the employee's salary is reduced, so is his income tax liability. Even with expenses that otherwise may be deductible, such as medical expenses, a salary reduction agreement can be advantageous if a floor on deductibility would otherwise apply. As explained below, a cafeteria plan can offer insurance options such as health, disability, or group term life insurance.

A cafeteria plan also may include one or more reimbursement accounts, i.e., flexible spending arrangements. Under these plans, cash that is foregone by the employee, through salary reduction or otherwise, is credited to a bookkeeping account maintained by the employer that the employer draws upon to reimburse employees for uninsured medical or dental expenses or for dependent care expenses. Certain special rules apply to health flexible spending arrangements. Many plans offer both insurance coverage and reimbursement accounts.

Requirements. A cafeteria plan must comply with basic requirements established by the specific Code section dealing with cafeteria plans, as well as any section of the Code prescribing rules applicable to the particular benefit being offered. A cafeteria plan, including a flexible spending arrangement, must be in writing and nondiscriminatory. In addition, a cafeteria plan generally may not include deferred compensation as an option.

Qualified benefits. A cafeteria plan may offer any qualified benefit other than scholarships and fellowship grants, educational assistance programs, medical savings accounts, long-term care insurance, and certain fringe benefits including no-additional-cost services, employee discounts, qualified moving expense reimbursements, and qualified transportation fringes. Qualified benefits include any other employer-provided welfare benefits that your employees are allowed to exclude from their income because of specific provisions of the law. Generally, qualified benefits include accident or health plans; dependent care assistance benefits, group term life insurance, and certain medical reimbursements. The cost of group term life insurance in excess of $50,000, and employer-provided dependent group term life insurance also may be provided even though they are includible in gross income.

Qualified benefits under a cafeteria plan are not subject to social security, Medicare, and Federal unemployment taxes, or income tax withholding. If an employee elects to receive cash instead of any qualified benefit, it is treated as wages subject to all employment taxes.

Inclusion of impermissible benefits in a cafeteria plan will cause such benefits to be treated as taxable benefits under the plan and the cafeteria plan as a whole will be prevented from qualifying under the Code.

An employee's election between cash and certain qualified benefits is irrevocable during the period of coverage except for changes in family status. Unless actually elected, the fact that cash or certain taxable benefits are available under the plan does not cause an employee to be treated as having received the cash or taxable benefit.

All participants in a cafeteria plan must be employees - either current or former employees. In addition, a cafeteria plan can pay benefits to spouses and other beneficiaries of employees but such spouses and other beneficiaries may not participate in the cafeteria plan.

Nondiscrimination rules. If, in any plan year, your cafeteria plan discriminates in favor of highly compensated individuals as to eligibility to participate in the plan or as to plan contributions or benefits, highly compensated participants are taxed on the amount of the taxable benefits that could have been elected.
An individual or participant is highly compensated if he or she:

1) Was a five-percent owner of the employer at any time during the year or the preceding year; or
2) Had compensation for the preceding year in excess of $80,000 (indexed for inflation) and, if the employer so elects, was in the top 20% employees by compensation for such year.

Nontaxable benefits to key employees. If your plan provides nontaxable benefits to "key employees" that are more than 25% of the total of the nontaxable benefits provided for all employees under the plan, key employees must include in income the value of the benefits that could have been elected. Key employees are those who during the plan year or any of the previous four plan years were:

1) Officers with compensation over a certain dollar amount;
2) The 10 employees with compensation over a certain dollar amount owning directly or indirectly the largest interests in the employer;
3) 5% owners of the employer; and
4) 1% owners of the employer with annual compensation over $150,000.

Collective bargaining agreement. If your plan is maintained under a collective bargaining agreement, it is not treated as discriminatory.

I have enclosed an appendix illustrating the potential savings to the employee and employer from using a §125 plan.

I hope that this has provided you with background information that will help guide you in determining whether your company's cafeteria plan complies and what types of plans are available. If you have any questions, please feel free to contact us.

APPENDIX
Example

For purposes of this example, let us assume that a corporation has a taxable income of $50,000 before paying one of their employees. Let us assume that the employee's annual salary is $30,000 and that, if available, the employee would utilize $5,000 in pre-tax cafeteria plan benefits.

Here's the corporation's situation with no plan:

Corporation:	Detail	Tax	Cash
Taxable income before		$ 50,000	$ 50,000
Salary	$ 30,000	$ (30,000)	$ (30,000)
FICA/Med deducted	$ (2,295)		
Employer matching FICA/Med		$ (2,295)	$ (2,295)
Taxable income		$ 17,705	
Tax (assume 20% rate)		$ (3,541)	$ (3,541)
After tax cash flow			$ 14,164

Here's the employee's situation with no plan:

Salary	$ 30,000	$ 30,000	
FICA/Med deducted	$ (2,295)		$ 27,705
Standard deduction		$ (4,750)	
Exemption		$ (3,050)	
Taxable income		$ 22,200	
Income tax		3,330	$ (3,330)
Spent on benefit items			$ (5,000)
Cash available for other purposes			$ 19,375

Now let's change the situation and implement a cafeteria plan. Here's the corporation's situation with a plan:

Corporation:		Detail		Tax		Cash
Taxable income before			$	50,000	$	50,000
Salary	$	25,000	$	(25,000)	$	(25,000)
FICA/Med deducted	$	(1,913)				
Cafeteria plan benefits			$	(5,000)	$	(5,000)
Employer matching FICA/Med			$	(1,913)	$	(1,913)
Taxable income			$	18,088		
Tax (assume 20% rate)			$	(3,618)	$	(3,618)
After tax cash flow					$	14,470

Here's the employee's situation with a plan:

Salary	$	25,000	$	25,000		
FICA/Med deducted	$	(1,913)			$	23,088
Standard deduction			$	(4,750)		
Exemption			$	(3,050)		
Taxable income			$	17,200		
Income tax				2,580	$	(2,580)
Cash available for other purposes					$	20,508

This example does not include the impact on unemployment taxes and worker's compensation insurance.

To summarize:

		No Plan		W/Plan		Savings
Employer	$	14,164	$	14,470	$	306
Employee	$	19,375	$	20,508	$	1,133
Total					**$**	**1,439**

This illustration only shows the savings for one employee. As you can see, this is has the potential to be a win/win situation. You should be cautioned, however, that the plan must be documented and the employer and employees must follow the provisions of the plan document.