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"CAFETERIA" PLANS: Benefits For Both Employers and Employees

A cafeteria plan is a separate written plan maintained by an employer for employees that meets the specific requirements of Internal Revenue Code section 125. It provides participants an opportunity to receive certain benefits on a pretax (income and FICA) basis. Participants in a cafeteria plan must be permitted to choose from a "menu" at least one taxable benefit (such as cash) and one qualified benefit.

Generally, a cafeteria plan does not include any benefit that defers pay. One exception is a qualified 401(k) plan. However, while these deferrals are not subject to income tax, they are taxable for FICA and FUTA.

IRS Requirements

Section 125 specifies the requirements for cafeteria plans: written documentation, certain reporting to the I.R.S., and limits on the frequency of employee changes to benefit elections. Particularly important, the tax preference of Section 125 will not apply to any benefit provided under the plan if the plan discriminates in favor of "key" or "highly-compensated" individuals as to eligibility to participate, or as to contributions and benefits. In cases of discrimination, the benefits selected by such "key" and "highly-compensated" employees will lose the tax exclusion.

What Benefits May Be Included?

A cafeteria plan offers employees an election among only permitted taxable benefits (including cash) and qualified nontaxable benefits. For this purpose, cash means cash from current compensation (including salary reduction), payment for annual leave, sick leave, or other paid time off, severance pay, property, and certain after-tax employee contributions. Distributions from qualified retirement plans are not cash or taxable benefits.

Employer-provided benefits permitted by Section 125 for a cafeteria plan include the following:

- Accident & health benefits (but not Archer medical savings accounts or long-term care insurance)
- Adoption assistance
- Dependent care assistance
- 401(k) Plan
- Flexible spending accounts
- Group-term life insurance coverage (including costs that cannot be excluded from wages)
- Health savings accounts, including distributions to pay long-term care services

Note that the exclusion from gross income of group-term life insurance premiums paid by the employer applies only to coverage up to and including $50,000. However, employers may include GTL coverage in excess of $50,000 as an option in a flexible benefits plan, even though federal income tax, and social security, Medicare and FUTA taxes apply to the cost of the excess amount of coverage. Importantly, however, employers are not required to withhold Federal income tax on such amounts, even though at year end the benefit will be taxable for the employee's calculation of Form 1040 tax liability.

What Benefits May Not Be Included?
Benefits prohibited from being included in a cafeteria plan include:

- Athletic facilities
- Commuting benefits
- De minimis benefits
- Educational assistance
- Employee discounts
- Lodging on your business premises
- Meals
- Moving expense reimbursements
- No-additional-cost services
- Tuition reduction
- Scholarships or fellowships
- Working condition benefits

Section 125 Flexible Spending Accounts
An important type of tax-exempt arrangement under Section 125 is the "flexible spending account" (FSA) which allows employees to pay for dependent care expenses (up to $5,000 per year), adoption assistance, and health care, on a pre-tax basis. However, interested employees must elect to fund the flexible spending account prior to the beginning of the plan year by allocating "flex dollars" (employer contributions) into the account or agreeing to a pre-tax wage deduction each payroll period. When such employees incur and pay for qualified expenses, they may submit proof of payment to their employer or plan administrator. The employee is then reimbursed up to the total amount they elected to contribute at the beginning of the plan year.

Medical expense spending accounts are the more common example of the FSA feature. They are designed to help employees pay medical expenses such as insurance deductibles and co-insurance amounts, or other health-related expenses such as dental, vision or hearing charges that are not covered by an employer's medical insurance plan.

There is no requirement to report reimbursements from medical expense FSA's. Some employers provide employees with periodic statements showing account transactions. Also, they may report total reimbursements at year end in Box 14 of Form W-2, which is used for employee convenience to report any "other" amounts paid. However, the Internal Revenue Service requires employers to report annually the amount of dependent care benefits PAID under a plan, in Box 10 of Form W-2. Likewise, adoption benefits PAID out under a Section 125 adoption expense FSA must be reported in Box 12 of Form W-2, using code "T."

Previously, amounts remaining in the flexible spending account at the end of the year must be forfeited. However, in 2005 the IRS added a provision that authorized an optional 2½ month grace period that employers can use in their plans, allowing use of the funds for 2½ months after the end of the plan year. Whether or not an employer allows a grace period, employees should be cautious not to over fund their FSA's with amounts greater than the expenses they expect to incur.

Advantages For Employers
An important reason for adopting a cafeteria plan is the tax saving that can be realized. Without a cafeteria plan, if the employee pays for the benefit, the payroll deduction does not lower the employee's taxable earnings. However, using a cafeteria plan, certain employee contributions may be paid on a pre-tax basis, so as to reduce taxable earnings, and thus reduce taxes. Importantly, both the employer and employee may realize tax savings under a cafeteria plan, because a reduction in the employee's taxable earnings also reduces the employer's match on employee FICA tax.

While a reduction in the employee's taxable wages theoretically would reduce the employer's FUTA tax liability, most employees earn more than $7,000 annually, so it merely defers briefly the employer's FUTA tax liability.

As for the employer's state unemployment compensation insurance contribution, because the state taxable wage limits vary and many are higher than the wage limit for FUTA tax, in some cases the employer's liability would be reduced. However, some states treat employee salary reduction amounts as taxable wages for purposes of the employer's state unemployment compensation insurance contribution.

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