



SECTION 125 OR CAFETERIA PLANS CAN THEY HELP YOUR COMPANY?

WHAT IS A CAFETERIA PLAN?

A cafeteria plan is a welfare benefit plan specifically authorized by Section 125 of the Internal Revenue Code. It is a way of providing employees with valuable benefits - where both the employer and employees can save significant amounts on taxes. Generally, employees are given a choice to "redirect" part of their salary. Each employee then uses the "redirected" part of his salary to purchase benefits from a "menu" of non-taxable benefits offered by the plan (hence the term "cafeteria").

Each employee selects the benefits he wants from the cafeteria plan menu. The "employee" pays for these benefits by electing to redirect his salary in an amount sufficient to pay for each benefit. Most importantly to each employee, these amounts are redirected from the employee's before it is subject to Federal Income Tax or Social Security taxes (FICA).

The redirected amounts are placed into a separate spending account for each benefit elected by the employee. Then, as each employee incurs a qualifying expense (e.g., a day care bill), he submits a claim to the plan administrator, who processes the claim and reimburses the employee from the money in the cafeteria plan.

There are significant benefits for both the employer and the employees. The primary benefit for employees is that they are not taxed on the salary they redirect into each benefit account, nor are they taxed when reimbursements are made. Therefore, through a cafeteria plan, employees can now pay for expenses with pre-tax dollars - the same expenses they were previously paying for with after-tax dollars.

For example, if an employee pays \$400 per month to have his children in a day care center, he can elect to have his salary reduced by \$400 and place this amount into the cafeteria plan dependent care account. Each month the employee submits a claim and is reimbursed for the \$400, which he has paid to the day care center. The employee has turned this expense from an after-tax expense into a pre-tax expense with the

cafeteria plan, and thus has more disposable income each month.

DO I HAVE TO REDESIGN MY EXISTING INSURANCE AND FRINGE BENEFIT PROGRAMS TO TAKE ADVANTAGE OF A CAFETERIA PLAN?

No, not at all. It will not require a change in either your group medical plan or group life plan. The premium payments made by employees are still handled through your payroll department - they are just converted to pre-tax, rather than deductions.

HOW WILL I, AS AN EMPLOYER, BENEFIT FROM INSTALLING A CAFETERIA PLAN?

Generally, you will benefit in four primary ways:

Saving Employment Taxes

You will not have to pay FICA or FUTA employment taxes on the gross amount of salary redirections made by your employees. In some states, state unemployment and workmen's compensation taxes can also be avoided on the amount of salary redirections. Because the salary redirection amounts remain in your company bank account until an expense reimbursement is made for an employee, you will earn interest on these amounts. Of course, the more your employees participate, the higher their salary redirections, the more you save each year.

You Can Participate

You, personally, will benefit by being a participant in the plan in the same manner as your employees. You can pay for your uninsured medical expenses, health premiums and dependent care with pre-tax dollars and end up with more disposable income, too. However, in a partnership, sole

proprietors and owners who own 2% or more of a Subchapter S Corporation cannot participate in a cafeteria plan.

Employee Morale

You will also benefit by providing a true employee benefit to your employees - one that will give them more disposable income each month. An employee's disposable income will rise because he will be paying for these ongoing expenses with pre-tax rather than after-tax dollars. Many employers find this helps promote loyalty, motivation and general employee satisfaction, with the resulting long-term benefits to your business.

Cost Containment

Some cafeteria plans can be designed and structured to provide employers with cost containment on the ever-increasing expense of providing fringe benefits - particularly with some forms of health plans.

EXACTLY WHAT BENEFITS CAN BE OFFERED AS PART OF A CAFETERIA PLAN?

The allowable non-taxable benefits include both insured and non-insured benefits:

- Accident and Health Insurance
- Group Term Life Insurance
- Disability Insurance
- Dental Insurance
- Dependent Card Assistance Programs (Day Care)
- Medical Reimbursement Plan (for non-insured medical expenses)

A cafeteria plan permits an employee to elect cash as an option from the plan "menu" in addition to these non-taxable benefits - an employee can therefore elect not to redirect his pay or purchase allowable benefits. Instead, the employee selects the cash option and receives his full salary. Obviously, this employee would pay taxes on the cash amount received.

These are the only benefits that can be offered in a cafeteria plan. A plan can offer some or all of the allowable benefits. You, the employer, choose which benefits to make available to employees. Employees, in turn select the benefits that most suit their needs.

WHAT KIND OF NON-INSURED MEDICAL EXPENSES CAN BE PAID FOR BY THE CAFETERIA PLAN?

Generally, any expense that is deductible under Section 213 of the Internal Revenue Code is included. Even co-pay amounts that employees pay as part of your group insurance or up-front deductible amounts that employees are required to pay themselves can be included.

WHO PAYS FOR THE CAFETERIA PLAN BENEFITS?

Most plans are set up to be funded only with salary redirections from participants. No contributions are required by the employer, although you can decide to make a contribution on behalf of all participants, if you choose.

The only requirement is for separate recordkeeping for each participant's account. Each selected benefit must be accounted for separately. As requests for reimbursement are made by each participant, the records detailing how much money remains in the account will need to be updated.

WHEN ARE SALARY REDIRECTIONS AND BENEFITS ELECTED?

Your cafeteria plan will operate on a 12 month plan year. Prior to the beginning of each plan year, each employee will select which benefits (if any) he wants to fund by redirecting a portion of his salary into the appropriate spending accounts. The elections, once made are irrevocable for that plan year. New elections must be made each year. Certain changes in family status, which arise during the plan allow a change in elections. These include marriage, divorce, death of spouse or child, birth or adoption, termination of spouse's employment, employment of spouse, switch between part-time or full-time.

Elections must be made carefully. If any money remains in a participant's account at the year end it does not get returned to the participant, nor does it get moved to next year's account. It remains in the general assets of the employer. "Use It or Lose It".

WHAT ARE THE REQUIREMENTS FOR INSTALLING A CAFETERIA PLAN?

The only requirement for installing a cafeteria plan is to adopt the plan, execute a plan document and have all eligible employees make their benefit elections. Summary Plan Descriptions, detailing the plan's eligibility requirements, benefits and election requirements, must be given to all employees. There is also an annual IRS reporting requirement, using Form 5500 and a general non-discrimination requirement that says no more than 25% of the reimbursements can be made to "key employees".

SHOULD I INSTALL A CAFETERIA PLAN?

With the savings on social security tax, limited administrative requirements and the ability to offer your employees a choice, it seems that the advantages outweigh the disadvantages.

Contact our firm if you would like further information on whether or not to install a cafeteria plan or how to proceed, if you have decided to do so.

This BMA was prepared by Kami Rathje of Howard Simon & Associates, Inc., 425 Huehl Road #20, Northbrook, IL 60062, 708-564-0340.