



## The Benefits of Cafeteria Plans

Start maximizing your employee benefits package--and saving money--with a section 125 flexible benefits plan.

By Trent D. Bryson | September 14, 2005

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One of the most underrated and underused employee benefits available for small businesses today is outlined in section 125 of the U.S. tax code. A section 125 or "cafeteria" plan allows employees to withhold a portion of their pre-tax salary to cover certain medical or child-care expenses. Because these benefits are free from federal and state income taxes, an employee's taxable income is reduced, which increases the percentage of their take-home pay. And because the pre-tax benefits aren't subject to federal social security withholding taxes, employers win by not having to pay FICA--or workers' comp premiums--on those dollars.

With so many advantages, why is the plan underused? The most likely reason is that these plans don't generate a lot of profit for benefit administration companies, and with little profits to earn, only minimal advertising is being done. That means many people are unaware the plan even exists. But utilizing the tax code for your business can be an incredible way to enhance your employee benefits package, while simultaneously boosting your margins.

Under a cafeteria plan, your employees can take advantage of three specific flexible benefits:

**1. Pre-tax health insurance premium deductions, also known as a Premium Only Plan (POP).** POP plans allow employees to elect to withhold a portion of their pre-tax salary to pay for their premium contribution for most employer-sponsored health and welfare benefit plans. The plan offers a simple way to obtain favorable tax treatment for benefits already offered. Most companies currently have this set up through their payroll provider. A POP plan is the simplest type of Section 125 plan and requires little maintenance once it's been set up through your payroll.

**2. Out-of-pocket unreimbursed medical expenses, also known as flexible spending accounts (FSAs).** An FSA allows an employee to fund certain medical expenses on a pre-taxed basis through salary reduction to pay for out-of-pocket expenses that aren't covered by insurance (for example, annual deductibles, office co-payments, prescriptions, over-the-counter drugs and orthodontia). The average working employee in America spends more than \$1,000 annually on these types of benefits. By participating in a FSA, an employee's taxable income is reduced, which increases the percentage of pay they take home.

**3. Dependent care flexible spending accounts.** The dependent care FSA is an attractive benefit for employees who pay for child-care or long-term care for their parents. Many employees don't take advantage of this benefit and may be unaware of the significant tax savings. Employees may hold back as much as \$5,000 annually of their pre-tax salary for dependent care expenses, which include expenses they pay while they work, look for work or attend school full time. Qualified dependent care expenses may include--but are not limited to--the care of a child under the age of 13, long-term care for parents, care for a disabled spouse or a dependent incapable of caring for himself, and summer day camps. In addition, by paying for dependent care with pre-tax dollars, your employees can save approximately 20 to 40 percent on their child-care expenses.

The best part about the Section 125 plan is that most of your employees are already paying for these expenses out of their own pockets with after-tax dollars. Cafeteria plans offer them a remarkable way to save money they're already spending.

Here's how it works:

- Prior to the beginning of each plan year, an employee estimates how much they'll spend in out-of-pocket medical expenses and/or dependent care expenses during the course of their plan year. (The plan year would be defined in their summary plan description).

Note: It's important for employees not to overestimate their annual election amounts, as the FSA is a "use it or lose it" benefit and they'll forfeit any unused balance remaining in the account at the end of each plan year. (There's a grace period for which an employee can file claims for each plan year.) If there's a FSA surplus at the end of the plan year, the remaining balance shall be retained by the employer to offset administrative expenses or future employee benefit costs.

- This amount is then deducted over the course of the plan year from their paychecks prior to being taxed and is deposited into their flexible spending account. On or after the first day of the plan year, an employee is restricted from changing or revoking the section 125 agreement with respect to the pre-tax premiums until the plan year has ended unless a "change in family status" occurs (as defined under the federal tax code) and the change is consistent with the "change in family status."
- Your employees would pay their out-of-pocket expenses upfront and then submit a claim and documentation to the plan administrator. A reimbursement would then be made from their own account with pre-taxed dollars and sent to them in the form of a check.

So what are the benefits to you as the employer?

- Every dollar ran through the 125 plan reduces an employer's payroll. Therefore, you don't have to pay FICA or workers' comp premiums on those dollars. In many cases, this savings can add up to as much as 20 percent of every dollar being passed through the plan.
- Implementing a cafeteria plan can "soften the blow" of premium increases to employees. For example, let's say a company's medical premiums are raised 10 percent for the year--a-not-unheard-of amount. Let's assume that 10 percent increase takes the premium for one of the company's employees, including their dependents, from \$800 to \$880 per year. Let's also assume the employer pays for 100 percent of the employee-only rate, which is \$200 in this example, leaving the employee responsible for the cost of his or her dependents (\$600). With a 10 percent increase on the portion the employee pays, the employee is now paying an additional \$60. If these additional costs are run through a POP plan, an employee in the 25 percent tax bracket would have an increase of just \$45, rather than \$60.
- Employees can use tax savings to invest in retirement plans. By using an FSA, your employees can save money on their everyday expenses, thus freeing up more of their income to be allocated to their 401(k) account, which increases participation.

And what are the benefits to your employees?

- Participating in a cafeteria plan reduces an employee's taxable salary and increases the percentage of their take-home pay, thus increasing their spendable income.
- They receive a greater deduction on dependent care expenses than what's offered by a traditional tax credit at the end of year.
- There's less of an impact on employees from insurance increases, such as premiums, co-pays, deductibles and so on. One of the most common ways for employers to keep benefit costs down is to simply lower the benefit levels of their plan offering. While this save you money on your premiums, your employees are then faced with greater deductibles, higher co-pays, higher prescription amounts and so on. Through the use of an FSA, employees can set aside money to cover these increased amounts, which lessens their out-of-pocket costs because they're setting aside tax-free dollars.

There are several administrative procedures that must be met to comply with Section 125 code legal requirements.

**1. A plan document must be established.** This document outlines specific details, such as a description of the employee benefits that are covered through the plan, participation rules, annual limits, election procedures, eligibility and employer contribution. It also defines the plan year.

**2. A summary plan description (SPD) must be distributed to all participants.** Section 104(b) of the Employee Retirement Income Securities Act of 1974 (ERISA), the basic law designed to protect the rights of participants and beneficiaries of employee benefit plans, requires that an SPD must be distributed to all participants no more than 90 days after an employee becomes a participant or within 120 days of the plan becoming subject to ERISA. A participant's beneficiary must also receive the summary plan description within 90 days after becoming eligible for benefits. The SPD summarizes specific details of the plan, claim filing procedures, and information concerning plan sponsorship and administration. In addition to distributing it to your employees and their beneficiaries, you must also file it with the Department of Labor within 120 days of the plan's effective date.

**3. There's ongoing compliance that must be attended to.** The laws are constantly changing and being updated. Federal legislation requires that section 125 plans can't discriminate as to eligibility and benefits being provided. Failure to meet the nondiscrimination requirements would eliminate the tax-free status of the benefits provided to the highly compensated and/or the key employees.

One of the best benefits for business owners is that cafeteria plans cost very little to set up and maintain. For most employers, the cost of implementing the plan is recovered through tax savings during the first year--you might even begin saving money as early as the month following the installation of a POP plan. So what are you waiting for? Now's the time to act--to benefit your employees and your business.

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