Increasing disposable income with a Cafeteria Plan

Commonly asked questions about Cafeteria Plans.
Table of Contents

What is a cafeteria plan? ..................................1
How does a cafeteria plan work? ......................1
Do I have to redesign my existing insurance to take advantage of a cafeteria plan? .............3
How will I, as an employer, benefit from installing a cafeteria plan? .............................3
Exactly what benefits can be offered as part of a cafeteria plan? ...................................6
What kind of non-insured medical expenses can be paid for by the cafeteria plan? ............7
Why would an employee elect non-insured medical expenses as part of the cafeteria plan? ........................................ 8
Why is a choice among benefits important? ....8
Who pays for the cafeteria plan benefits? ......9
When are salary redirections and benefits elected? .........................................................10
Once the election is made, can the participant change his mind during the year? ............10
What happens if there is money left in the participant’s account at the end of a year? ......11
What are the rules regarding reimbursements to participants for non-insured medical expenses? .................................12
Are there any employees that cannot participate in a cafeteria plan? ..........................12
What are the requirements for installing a cafeteria plan? ........................................... 12
After the plan is installed, what responsibilities will the employer have? ...............13
Are there limits on how much each participant can elect to put into any single benefit?........14
What about future legislation that may affect the advantages of cafeteria plans? ........14
Should I install a cafeteria plan? .................15
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 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”).

The employer may make further contributions to the plan (in addition to an employee’s own salary redirections) which employees may also use to purchase allowable benefits. Allowable benefits include dependent care assistance programs (day care), uninsured medical expenses not covered by the typical group medical plan, group life, medical, and disability premiums otherwise paid by the employee, and contributions to 401(k) plans. Because cafeteria plans allow employees to choose the benefits they want, they are often referred to as flexible spending or flexible benefit plans.

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 salary 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. See the example on page 5.
Do I have to redesign my existing insurance 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, unless of course you would be changing them independent of any possible addition of a cafeteria plan. The premium payments made by employees to cover their dependents are still handled through your payroll department — they’re just converted to pre-tax, rather than after-tax, 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 worker’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. An example can best explain the savings to you:

| Total Amount Salary Redirections by Employees | $60,000 |
| Savings in FICA at 7.65% | 4,590 |
| Interest on $60,000 at 3% | 1,800 |

Estimated Savings $ 6,390

Of course, the more your employees participate, and 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, dependent health premiums and dependent child care with pre-tax dollars and end up with more disposable income, too.

Employee Morale
You 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.
The following example illustrates the savings to a typical employee.

<table>
<thead>
<tr>
<th></th>
<th>Without Cafeteria Plan</th>
<th>With Cafeteria Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Monthly</td>
<td>$ 1,000.00</td>
<td>$ 1,000.00</td>
</tr>
<tr>
<td>Compensation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less Pre-Tax Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Medical Expense</td>
<td>25.00</td>
<td></td>
</tr>
<tr>
<td>• Dependent Child Care</td>
<td>200.00</td>
<td></td>
</tr>
<tr>
<td>• Group Medical Insurance Premium</td>
<td>50.00</td>
<td></td>
</tr>
<tr>
<td>• Group Life Insurance Premium</td>
<td>2.00</td>
<td></td>
</tr>
<tr>
<td>Gross Taxable Income</td>
<td>$ 1,000.00</td>
<td>$ 723.00</td>
</tr>
<tr>
<td>Less Taxes and After-Tax Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Federal Income Tax at 20%</td>
<td>$ 200.00</td>
<td>$ 144.60</td>
</tr>
<tr>
<td>• State Income Tax at 10%</td>
<td>100.00</td>
<td>72.30</td>
</tr>
<tr>
<td>• Social Security Tax at 7.65%</td>
<td>76.50</td>
<td>55.31</td>
</tr>
<tr>
<td>• Group Medical Insurance Premium</td>
<td>50.00</td>
<td></td>
</tr>
<tr>
<td>• Group Life Insurance Premium</td>
<td>2.00</td>
<td></td>
</tr>
<tr>
<td>Net Paycheck</td>
<td>$571.50</td>
<td>$450.79</td>
</tr>
<tr>
<td>Plus Cafeteria Plan Reimbursements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Medical Expense Reimbursement</td>
<td>$ 25.00</td>
<td></td>
</tr>
<tr>
<td>• Dependent Child Care Reimbursement</td>
<td>200.00</td>
<td></td>
</tr>
<tr>
<td>Disposable Income</td>
<td>$571.50</td>
<td>$ 675.79</td>
</tr>
</tbody>
</table>

Estimated Increase in Disposable Income per Month $ 104.29
Estimated Increase in Disposable Income per Year $ 1,251.48
These savings represent an increase of 18% in this employee’s disposable income — a substantial effective pay increase.

Exactly what benefits can be offered as part of a cafeteria plan?

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

Insured Benefits
- Accident and Health Insurance
- Group-Term Life Insurance
- Disability Insurance
- Dental Insurance

Non-Insured Benefits
- Dependent Care Assistance Programs (Day Care)
- Medical Reimbursement Plan (for non-insured medical expenses)
- 401(k) Plan
- Vacation Days
- Health Savings Accounts

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?

The following list includes examples of expenses that may be paid under the cafeteria plan. It includes, generally, any expense that is deductible under Section 213 of the Internal Revenue Code (other than insurance premiums and long-term care services).

- Ambulance hire
- Artificial limbs and teeth
- Automobile modifications (hand controls, special equipment, mechanical lifts)
- Birth control pills (with limitations)
- Drugs (legal) and medical supplies
- Eyeglasses
- Fees:
  - Anesthetist
  - Blood donor
  - Chiropractor
  - Dentist
  - Examination, physical
  - Eye examination
  - Gynecologist
  - Hospital
  - Laboratory
  - Nurse
  - Ophthalmologist
  - Optician
  - Optometrist
  - Oral surgery
  - Osteopath
  - Pediatrician
  - Physician
  - Physiotherapist
  - Podiatrist
  - Psychiatrist
  - Psychologist
  - Psychoanalyst
  - Non-cosmetic surgery
  - Therapy
• Hearing devices
• Hospital bills
• Obstetrical expense
• Operations & related treatments
• Oxygen equipment
• Sanitarium or rest home
• Support or corrective devices (including special mattress and board for arthritis)
• Transportation expense relative to illness
• Vasectomy
• X-rays

Why would an employee elect non-insured medical expenses as part of the cafeteria plan?  The medical reimbursement plan you could offer in a cafeteria plan could cover expenses not covered by your group medical insurance plan. That might include expenses like those discussed above, co-pay amounts that employees pay as part of your group insurance or deductible amounts that employees are required to pay themselves.

Why is a choice among benefits important?  Not all employees have the same needs. For example, some employees have spouses who are employed on a full-time basis and covered by a health insurance plan. Such employees may not need dependent health insurance under your company’s plan — but would prefer to purchase more life insurance instead. Other employees with working spouses and young children may opt for dependent care (day care) coverage. However, if the employee’s spouse stays in the home and takes care of the children, dependent
health insurance coverage will probably be the most important benefit.

Cafeteria plans give employees the opportunity to choose the benefits most important to their particular situations — and to pay for these benefits on a tax-advantaged basis. Employees appreciate this unique approach, and the savings they realize as well.

**Who pays for the cafeteria plan benefits?**

Most cafeteria 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. We can provide the recordkeeping service for your plan, or recommend ways to handle it.

Each benefit that the participant has selected 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. Actual reimbursements can be made through your payroll department, or by checks issued through your cafeteria plan administrator.
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. Conservative estimates should be used to ensure that the employee’s reimbursements will use up his entire account during the year. We will work with you to help in this important election phase each year.

Once the election is made, can the participant change his mind during the year?

The elections, once made, are generally irrevocable for that plan year. New elections are made prior to the beginning of each subsequent plan year.

However, certain situations can arise during the plan year which may allow a participant to change an election. These situations generally include:

1. Legal marital status changes such as marriage, divorce, separation, or the death of a spouse.

2. A change in the number of dependents due to birth, death or adoption.

3. Changes in employment status of the participant or the participant’s spouse or dependent, such as a change or increase in hours, strike, change from full-time to part-time or vice-versa, the beginning or end of an unpaid leave of absence, termination of employment, or change in worksite.
4. A dependent becoming eligible or ceasing to be eligible for coverage due to age or student status.

5. A change in the residence of the participant or the participant’s spouse or dependent.

**What happens if there is money left in the participant’s account at the end of a year?**

In that case, the participant forfeits the money in the account and the money remains as a general asset of the employer. This is the “use it or lose it” feature of a cafeteria plan that you may have heard of. However, you may add an additional “grace period” of up to 2½ months after the end of the plan year to allow participants to use up monies left in their accounts.

For this reason, participants need to make conservative estimates of their reimbursable expenses prior to each plan year. Dependent child care and group medical and life insurance premiums are generally easy to estimate. Medical expenses not covered by insurance are harder to predict. However, experience shows that when a participant is informed that he has money left in his account and the year is coming to an end, he’ll then go for the checkup he’s been putting off, or get that new pair of glasses he’s needed, etc. With proper planning, forfeitures are therefore quite uncommon.

Communication of the cafeteria plan and its benefits is critical to the success of the plan. We can recommend different methods of enhancing the communication process to help make your plan more successful.
The rules require that participants be reimbursed for the full amount of their request, even if the participant hasn’t yet redirected enough salary into his account to cover the entire amount. The only requirement is that the request for reimbursement not exceed the total amount the participant has elected to set aside in that account for the entire year.

We can recommend several ways to eliminate possible employer risk if an employee were to terminate. For example, one method might be to place limits on the amounts that participants can redirect into a medical reimbursement account. There are also other methods we can discuss.

Partners in a partnership, members of a limited liability corporation, sole proprietors and owners who own 2% or more of a Subchapter S Corporation cannot participate in 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.
employees. There is currently no initial filing for a determination letter with the IRS, as there is for pension or profit sharing plans.

One of the factors most critical to the success of a cafeteria plan is the communication and enrollment process for employees. If care is taken in informing employees of the advantages of cafeteria plans and in signing them up, there is a much greater likelihood of success.

We can provide you with all of these plan installation items and services, or advise you how to handle them.

If the plan covers non-insured benefits, then administrative recordkeeping will be required for the accounts of each participant — tracking money that comes into each account through payroll deductions and reimbursements as they are paid. Plans that provide for insured benefits only require less administrative recordkeeping — the payroll department can merely adjust employee-paid premiums to pre-tax dollars rather than after-tax payments.

Also, participants should sign new election forms each year, deciding which cafeteria plan benefits they want for the upcoming plan year.
There is a $5,000 limit on expenses that may be paid each calendar year for dependent care benefits for married couples who file joint returns. Other than that, there are no limitations on amounts allocated to particular benefits. However, there is a general non-discrimination requirement that says no more than 25% of the cafeteria plan’s reimbursements can be made to “key employees.” A key employee is generally defined as someone who owns more than 5% of the company, is an officer earning more than $130,000 (as indexed for the cost of living) or owns 1% or more and earns more than $150,000. If the 25% reimbursement limitation is exceeded, the reimbursements may be included in the income of the applicable key employees for income tax purposes.

Before you institute a cafeteria plan, you should determine whether this discrimination test is likely to cause any problems. Generally, companies with 25 or more employees do not violate these tests — and many smaller companies qualify as well.

Obviously, it is impossible to predict what Congress may do in the future. However, Congress recently considered curtailing some of the tax advantages of cafeteria plans — and, after careful consideration, decided not to place restrictions on these plans. Congress generally felt that cafeteria plans provide a valuable method of delivering necessary welfare benefits.
to employees, including rank and file employees. Cafeteria plans are therefore likely to remain popular for the foreseeable future.

**Should I install a cafeteria plan?**

Many employers have been faced with the same question, and have decided to implement a cafeteria plan. Their reasons included:

- They felt their employees would appreciate the “choice” aspect of cafeteria plans — picking and choosing benefits most suited to their needs.

- Employees also appreciate the increase in disposable income produced by paying expenses through the tax advantaged cafeteria plan.

- Employers will save considerable sums through reduced social security tax obligations; these savings are usually sufficient to cover most or all of the plan implementation and annual administration costs.

- Providing employees with this type of fringe benefit plan provides a competitive edge for an employer in attracting and retaining good employees.

- Basically, employers feel these and other advantages far outweigh the administrative responsibilities these plans entail. These employers agree that cafeteria plans provide a new and unique method for providing
employees with benefits they want and need in a cost-effective manner.

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