

Cafeteria Plan

A Low-Cost Employee Benefit

What is a Cafeteria Plan

Section 125 of the Internal Revenue Code provides employers the opportunity to give employees a variety of benefits, at the option of the employee – hence it's name, Cafeteria Plan.

Cafeteria Plans are most often associated with medical insurance, medical flexible spending accounts, and dependent care flexible spending accounts, but can provide other benefits to employees, such as parking, dental, life insurance and disability insurance.

The basis behind the Cafeteria Plan is that employees may choose to voluntarily reduce their taxable compensation in exchange for certain benefits. If the employee chooses not to enroll in any of the benefits offered, the employee receives his or her full compensation.

In essence, the Cafeteria Plan does one of two things: provides employees with more after-tax dollars by reducing their tax liability or, perhaps more importantly, put the cost of medical coverage within reach of employees.

An Example of Savings

Assume an employer offers medical insurance to its employees, but does not pay any of the premiums, a situation quite common to small companies. Monthly premiums can run \$600-700+ for a family policy. Total annual cost for our purposes will be \$8,400.

Also assume that an employee regularly has several thousand dollars in out-of-pocket medical expenses, from co-pays, prescriptions, even over-the-counter medications. We will use \$4,000 a year.

Absent a Cafeteria Plan, the employee would pay for these expenses using income that has already been subject to income tax. In our scenario, the employee would have to earn in excess of \$19,000 in order to have enough money to pay the taxes on the income and then have enough left over to pay the insurance premiums and out-of-pocket expenses.

With a Cafeteria Plan the employee only needs to earn the exact cost of these benefits, a savings of over \$6,500.

Employer Benefits

The advantages of a Cafeteria Plan are not all one-sided. Benefits can also extend to employers who offer Cafeteria Plans, in more ways than one.

Because funds diverted by an employee into their Cafeteria Plan are not included in taxable wages, the employer experiences a modest reduction in payroll taxes, including social security, Medicare, worker compensation insurance and unemployment. These savings can help to offset the minimal cost in establishing and maintaining a Cafeteria Plan.

Another benefit to the employer is the ability to attract and retain qualified employees. Employees who have experienced the cost savings provided by a Cafeteria Plan will look to continue receiving those benefits.

Perhaps one disadvantage to employers is that depending on the entity structure, owners of the business may not be able to participate in the Cafeteria Plan, a consequence that may prompt owners to re-evaluate the chosen entity.

Establishing and Maintaining a Plan

A Cafeteria Plan can be accomplished through the adoption of several agreements by the employer. Decisions need to be made regarding who will administer the plan, keeping in mind the need for confidentiality of medical records.

Annual record keeping must be maintained in order to insure the internal integrity of the plan and to verify benefits to be paid to participants. While separate checking accounts and general ledger accounts are not required, some form of bookkeeping for the Plan must be established.

Maintenance of a plan does require an annual tax return filing, reporting certain aspects of the benefit plan to the IRS. Employees will also need to complete annual election forms declaring the extent of their participation for the plan year.

If you have questions about Cafeteria Plans, consult an attorney.

Deidre A. Liedel, JD, CPA

LaValley, LaValley, Todak & Schaefer Co., L.P.A.

deidre.liedel@lavalley-law.com

419-882-0081 (voice)

www.lavalley-law.com

419-882-4635 (fax)