Section 125 Cafeteria Plan

https://www.tasconline.com/biz-resource-center/plans/section-125-cafeteria-plan/

A Cafeteria Plan (includes Premium Only Plans and Flexible Spending Accounts) is an employee benefits program designed to take advantage of Section 125 of the Internal Revenue Code. A Cafeteria Plan allows employees to pay certain qualified expenses (such as health insurance premiums) on a pre-tax basis, thereby reducing their total taxable income and increasing their spendable/take-home income. Funds set aside in Flexible Spending Accounts (FSAs) are not subject to federal, state, or Social Security taxes. On average, employees save from $.25 to $.49 for EVERY dollar they contribute to the FSA.

Premium Only Plan (POP)

Employers may deduct the employee's portion of the company-sponsored insurance premium directly from said employee's paycheck before taxes are deducted.

Flexible Spending Account (FSA)

In an FSA, employees may set aside on a pre-tax basis a pre-established amount of money per plan year. The employee can use the funds in the FSA to pay for eligible medical, dependent care, or transportation expenses.

Benefits to the Employer

Employers may add an FSA Plan as a key element in their overall benefit package. Because an FSA Plan offers a tax-advantage, employers experience tax savings from reduced FICA, FUTA, SUTA, and Workers' Compensation taxes on participating employees. These tax savings reduce or eliminate altogether the various costs associated with offering the plan. Meanwhile, employee satisfaction is heightened because participating employees experience a "raise" at no additional cost to the employer.

Increased participation equals greater tax savings to the employer. Thus, to promote participation in the plan, employers may wish to contribute to each employee's FSA account.

Benefits to the Employee

An employee who participates in the FSA must place a certain dollar amount into the FSA each year. This "election" amount is automatically deducted from the employee's check (for that amount divided by the number of payroll periods). For example, an employee is paid 24 times a year, and elects to put $480 in the FSA. Thus, $20 is deducted pre-tax from each paycheck and is held in an account (by the plan administrator) to be reimbursed upon request.

Plan Year and Grace Period

The plan year is one full year (365 days) and generally begins on the first of a month. Many employers design their flexible spending plan to run on the same plan year as their insurance program. Short plan years are allowed in certain instances.

The grace period is a timeframe up to 75 days after the end of the official plan year during which employees may use up any funds remaining at the end of the plan year. For example, if the plan year runs from July 1-June 30, the grace period for that plan may continue up to September 15. If an employee incurs an expense after June 30 but before September 15, they can utilize the remaining funds from the previous plan year and submit requests for reimbursement. In addition to the 75 day grace period, plan participants have an additional 90-day run-out period in which they can submit requests for reimbursement for expenses incurred during the dates of service within the plan year *and* grace period.

Uniform Coverage

This aspect of Section 125 allows an employee to be reimbursed for qualified medical expenses that exceed their contributions to date. While this is a great benefit for the employee, it poses a potential risk to the employer. A case in point is when an employee terminates with a negative balance in their medical FSA. This risk should be offset because some other employees do not spend all of their FSA funds, so the risk is minimal.

This rule states that for the medical expense account, a participant may claim the full amount of their annual election even if they have contributed only a portion of the total. For example, Sue Summers decides to contribute $480 for the year to her FSA account. To accomplish this, $20 is deducted pre-tax from each of her 24 payrolls for the year. Her plan starts in January. In March, Sue experiences a medical expense that costs $400. To date, she has contributed only $20 on six payrolls, meaning she has only $120 actual dollars in her FSA account. However, due to the uniform coverage rule she can claim and be reimbursed for the full $400 because of the assumption that her bi-weekly contributions will continue and she will eventually contribute the $480 total. This honor system is a huge advantage for participants, and allows them to experience medical expenses at any time of the year with no worry about having the funds available at the time the expense is incurred.

Uniform coverage applies to the medical FSA only; it does not apply to a Dependent Care FSA. With a Dependent Care FSA account, a participant's reimbursement may not exceed the balance in the FSA account at the time the claim was made.

The Use-It-Or-Lose-It Rule and Carryover

This rule states that any funds remaining in the participating employee's FSA account at the end of the plan year will be forfeited to the employer. Although the rule is clear, many users of an FSA largely misunderstand the result of the rule: loss of funds can be easily avoided.

Let's look at an example: Joe Smith chooses to participate in the Medical FSA and elects to fund $500 for the year. After the plan year and grace period are complete, Joe finds that he spent only $400 of the original $500 he put away. He fears he has lost $100, but due to the taxes he saved on the $500 he has not. Let's say Joe is in the 28% tax bracket. By putting $500 away in his Medical FSA, he saved $140 in taxes (money that was not taken out of his paycheck and given to the IRS). In sum, even if Joe leaves $100 in his Medical FSA account, he has still saved $40! This vital key issue must be explained completely to potential FSA participants.

Plus, with the new Carryover provision implemented on October 31, 2013, employees can carryover up to $500 of unused Medical FSA funds from one plan year to the next with no fees or penalties. Carryover enures the participating employee a safety net when determining how much money to set aside in a medical FSA each year. Employees can contribute funds with more confidence, knowing that they will not lose their funds (maximum carryover is $500) at the end of the plan year.

Employees who participate in an FSA should determine the amount to fund by looking at the expenses they will incur in a year; this amount is not an arbitrary number. In this example, let's say Mary Johnson is married with two children. One child is in daycare, Mary has glasses, and her husband Tom has allergies. When adding up how much to put away in her Medical and Dependent Care FSA accounts, Mary looks ahead for the year and determines that one child is going to need braces (add $2,000), that Mary is going to need glasses (add $500), and that Tom has a regular prescription for allergy medicine every month (add $120: $10 per month co-pay). Adding it all up, she determines her expenses add up to $5,000 for day care and $2,620 for medical expenses. Since the limit on the medical FSA for 2015 is $2,550 ($2,500 for plan years with a start date in 2014), Mary will elect $2,550 for the Medical FSA and $5,000 for the Dependent Care FSA. The total amount she will put away toward her FSA is $7,550. **These are expenses she knows will be incurred.** Once again, at an average 28% tax bracket, Mary will save $2,114 by using her FSA! That is equivalent to getting her child's braces for free! She has no doubt that she should take advantage of her FSA and save this money.

Cafeteria Plans are qualified, non-discriminatory benefit plans, meaning a discrimination test must be met based on the elections of the participants combined with any contribution by the employer.

Nondiscrimination Testing

Section 125 of the Internal Revenue Code requires that Cafeteria Plans be offered on a nondiscriminatory basis. To ensure compliance, the Internal Revenue Code sets forth testing requirements that must be satisfied. These testing requirements are in place to make certain that Cafeteria Plan benefits are available to all eligible employees under the same terms, and that the Plan does not favor highly compensated employees, officers, and owners.

Exceptions

Sole proprietors, partners in a partnerships, and more-than-2% shareholders in an S-Corporation have special considerations concerning participation in a Cafeteria Plan.

While sole proprietors cannot directly participate in the plan, they may legitimately employ their spouse and offer the spouse the benefits of the plan. In such instances, the employer must take care to ensure that the plan must be offered on a non-discriminatory basis. The employed spouse may be considered a highly-compensated employee and as such their contributions to the plan may be limited.

A partnership operates much like a sole proprietorship. While the partners cannot directly participate, they may employ a spouse who in turn may receive benefits. The highly compensated issues apply as stated above.

While all non-related employees may participate in the plan, depending upon the plan's parameters, non-discriminatory rules apply.

In S-Corporations, eligible employees who are not shareholders and who are not defined as highly compensated generally may participate to the fullest extent. Eligible employees, who are defined as highly compensated, excluding shareholders, will be subject to the non-discriminatory rules.

Special rules apply to a more-than-2% shareholder of the organization. These individuals may not participate in the plan; nor may their employee-spouse, children, parents, and grandparents. In determining the status of an individual that becomes or ceases to be a more-than-2% shareholder during the course of the S Corporation's taxable year, the individual is treated as a more-than-2% shareholder for the entire year.