



Section 125: Cafeteria Plans

The Last Free Lunch?

by Meredith Clark

As the old adage goes, there's no such thing as a free lunch. Unless, of course, you are talking about Section 125 Cafeteria Plans. Most employee benefit plans cost money. They require either an employer or employee contribution or a combination of the two to pay for benefits. However since 1978, Section 125 of the IRS Code has allowed employers to offer Cafeteria Plans, a valuable benefit that saves both the organization and their employees money. Originally an elite benefit offered only by large companies, Cafeteria Plans are recognized by organizations of all sizes today as valuable and cost-effective benefits.

Sometimes these plans are referred to as "Flexible Compensation", "Flexible Benefit", "Flex" plans. Whatever name they go by, the central concept is that each employee's spendable income is increased to allow them to select and pay for certain benefits using pretax dollars. Pretax benefits typically include: 1) the employee's share of health, disability and life insurance premiums; 2) unreimbursed medical expenses such as copays, deductibles, and expenses not covered in their health/dental plan; and 3) work-related dependent care expenses. Normally these expenses would be paid with after tax dollars. However, through a Cafeteria Plan, each participant's gross income is reduced by the cost of the expenses. This reduction in taxable income results in a savings in taxes such as federal, social security and state taxes. This can result in an annual savings of hundreds of dollars for many employees.

Nonprofits can also enjoy a substantial savings by offering a Cafeteria Plan. When an employee's taxable income is reduced by their pretax contribution, your agency saves on FICA and workers' compensation premiums. According to Word & Brown Insurance Administrators, a typical employer saves approximately 10% of the dollars that employees contribute to the plan. For most employers, this savings more than offsets the cost of administering the plan.

Here's an overview of various Cafeteria Plans. Each type of plan has flexibility and can be custom designed to best fit the needs of your agency.

Premium Only Plans (POPs)

Cafeteria plans take many forms based on the type and number of benefits offered. Plans that only offer the pretax payment of insurance premiums are called Premium Only Plans (POPs) and are the simplest form of a Cafeteria Plan. Following the initial setup and enrollment of a POP, there is little ongoing administration required. Premium dollars are simply deducted from the employees' pay check on a pretax basis with the resulting increase in spendable income reflected in their take home pay.

Flexible Spending Accounts (FSAs)

Flexible Spending Accounts (FSAs) are plans that enable employees to pay for items such as dependent care and unreimbursed medical expenses with pretax dollars. The IRS allows a wide array of medical expenses, including: deductibles, co-payments, acupuncture, addiction treatment, birth control pills, chiropractor fees, eyeglasses, dental expenses, orthodontics and many other expenses not covered under an employee's insurance plan.

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Employee Savings		
	BEFORE CAFETERIA PLAN	WITH CAFETERIA PLAN
Employee Salary	\$2,000	\$2,000
Tax Free Benefit (Re-directed from salary on pre-tax basis)	0	300
Taxable Income	2,000	1,700
Taxes (Average 28%)	560	476
FICA @ 7.65%	153	130
Take-Home Pay	1,287	1,094
After-Tax Benefit Expenses	300	0
Spendable Income	\$987	\$1,094
Employee Monthly Increase		\$107
Annual Employee Increase		\$1,284

Employer Savings		
<i>Based on 30 Employees, Average \$2,000/mo. Salary</i>		
	BEFORE CAFETERIA PLAN	WITH CAFETERIA PLAN
Employee Salary	\$2,000	\$2,000
Employee Cafeteria Contribution	0	300
Taxable Salary	2,000	1,700
FICA @ 7.65%	153	130
Workers' Comp (Av. 5%)	100	85
Total Employee Payroll	2,253	2,215
Monthly Agency Saving Per Employee		\$38
Annual Agency Saving Per Employee		\$456
First Year Savings		\$13,680

At the beginning of each plan year, employees estimate their unreimbursed medical expenses and dependent care expenses for the coming year. Funds are then deposited into their Flexible Spending Account. Participants submit claims and are reimbursed with their own tax-free dollars. The amount of tax savings is directly proportionate to the dollars redirected into the Plan. Therefore, an employee with an abundance of qualified expenses will benefit more than an employee who has little or no out-of-pocket health or day care expenditures. More administration is involved with an FSA than with the Premium Only Plan, but employers and employees agree it is well worth the effort when the overall increase in tax savings is considered.

Full Cafeteria Plans

The name "Cafeteria Plan" describes a program which allows employees to select from an array of benefit options—just as they might choose from an array of food choices at a cafeteria. Employers can designate a certain dollar benefit, or benefit "allowance", and each employee decides how to best apply it to their needs: single employees can choose health coverage with the remainder of the allowance going to retirement or as a cash supplement to their salary; employees with families may choose to cover their full family on health insurance and a life insurance policy; or an employee can choose to take the full allowance as salary.

Unlike POP and FSA plans which are being offered in more and more organizations, Full Cafeteria plans are on the decline. Insurance participation requirements and the high cost and complexity of administering Full Cafeteria Plans are reducing the number of employers offering this type of plan. Most health insurance carriers now require 60%-80% of your eligible employees to enroll in a health plan and many life insurance companies require all employees to participate in the coverage. A full Cafeteria Plan with voluntary participation in the health and life plans sometimes makes it difficult for an employer to meet the insurance company's requirements. Also, a Full Cafeteria Plan is custom designed for an organization, making the setup and ongoing administration costs high.

Which Plan Is Best For Your Organization

The type of Cafeteria Plan an organization should offer depends on agency size, employee premium contribution, health plan options and the prevalence of employees with dependent care expenses. Implementing a Cafeteria Plan will always save money for those employees who pay a share of their insurance premiums, have out of pocket medical expenses, and/or have work-related childcare expenses. However, the savings for an agency will depend upon the number of participants in a plan. Although not applicable to all situations, generally groups with as few as five employees can often implement a POP and save money for both the employer and employee. Similarly, employers with 25 or more employees can implement the more complex Flexible Spending Account Plans and realize substantial net savings.

Plan Administration & Cost

To qualify for the benefits of a Cafeteria Plan, an employer must abide by the rules governing Section 125. There are several legal requirements that must be satisfied or a hefty fine will be imposed by the IRS. The plan must be a written plan. A summary plan description must be developed and distributed to all plan participants. The plan must be communicated to all eligible employees and offered on a nondiscriminatory basis. Additionally, the employer must file a Form 5500 with the IRS at each year's end.

A competent Section 125 Cafeteria Plan administrator will be able to assist your organization in performing all phases of plan design, set-up, employee communication, ongoing administration and plan filings. A reputable administrator is licensed and bonded, experienced in the field of benefit administration, carefully monitors legislation and keeps the organization up-dated on any changes in the IRS Code. The one-time cost to set up a POP usually runs less than \$500 and most agencies find that this cost is more than made up by the agency's savings in workers' compensation and Social Security taxes within the first year. To maintain the POP in subsequent years will cost between \$100 to \$200.

The Flexible Spending Account (FSA) is more complex and costly to implement. Most administrators charge a flat fee, in the neighborhood of \$500, for the documentation and setup of an FSA. In addition, there are monthly administration fees which range between \$3.00 to \$5.00 per participant, with a minimum monthly charge by the administrator. These fees can be passed on to the employee. However, most employers find that paying the fees themselves encourages participation in the plans and ultimately saves the agency money. The cost of a FSA account will vary depending on the number of employees participating but most nonprofits find that their workers' compensation and FICA savings exceed the administrative cost by the second year of the program.

Similarly, Full Cafeteria Plans include flat administrative costs and monthly fees. The costs can vary widely and are based upon the complexity of the Plan's design. In addition to an outside administrator, nonprofits must have in-house administration capable of providing both the employees and administrator with on-going support and information.

Conclusion

While Cafeteria Plans may not be everyone's idea of a free lunch, they can offer a valuable savings benefit for both you and your employees. If you are interested in checking into a plan for your agency, contact a reputable, competent Section 125 administrator. Your insurance broker or auditor should be able to supply you with a list of names. After supplying minimal information, an administrator, at no charge, will provide you with a proposal outlining the savings to both your employees and organization. Be sure to review the proposal closely and remember if you decide to implement a Section 125 plan, that in order to avoid painful penalties by the IRS, you must comply with all reporting and administration requirement of Section 125.

Nonprofits insured through CAN Insurance Services (CIS) may contact CIS for assistance in obtaining more information on Cafeteria Plans and a customized proposal for your organization. ■