

# Cafeteria Plans

## *What Is a Cafeteria Plan?*

An employee cannot usually avoid taxation on earned income by refusing to accept such income once it is made available. So, absent some special exception, if an employer offered an employee a choice of receiving cash or comparable compensation in some other form that is normally nontaxable (say, medical or disability insurance), then the cash-equivalent would usually be included in the employee's gross income. Fortunately, there is such an exception--Code Section 125.

Section 125 allows the employer to establish what is often called a "cafeteria plan" or a "flexible benefits" program. When the employer establishes such a program that meets the Section 125 requirements, the employee may freely choose from a "compensation menu" that includes both taxable and nontaxable benefits without rendering the nontaxable items subject to income tax.

## **Eligibility**

Cafeteria plan benefits can only be provided to employees, former employees and the beneficiaries of employees. Beneficiaries of employees, however, cannot themselves participate in the program. Self-employed persons are not treated as employees.

## **Benefits Permitted**

Section 125 generally divides benefits into two groups:

cash and currently taxable benefits, called "cash benefits," and certain nontaxable benefits, called "qualified benefits."

## **Cash Benefits**

A compensation benefit is treated as "cash" if:

it was purchased with after-tax compensation, or is treated by the Internal Revenue Code as if it were, and  
it does not result in the deferral of income.

For example, premiums paid for personal disability income insurance are normally not deductible. When employees use their option in a cafeteria plan to purchase disability income insurance, this is a "cash benefit."

## **Qualified Benefits**

To be considered "qualified," the benefit generally must:

be excludable from gross income under certain other Code provisions (not all tax-favored benefits are "qualified benefits"), and  
not result in the deferral of income, except that 401(k) plans are permitted.

For example, an employer can usually reimburse employees for out-of-pocket medical expenses, and Code Section 105 applies to exclude these reimbursements from the employee's gross income. Thus, this would be a "qualified" benefit that could be offered under a cafeteria plan.

Although group term life coverage under IRC Section 79 in excess of \$50,000 can result in gross income to the insured employee, it is still treated as a qualified benefit for cafeteria plan purposes.

### **Post-Retirement Life Insurance**

The law specifically allows cafeteria plans to provide post-retirement life insurance for the employees of tax-exempt school systems only. The life insurance may not build a cash value, and all contributions must be made before retirement.

### **Other Benefits**

Any option that is not cash or a qualified benefit will disqualify the plan under Section 125. For example, certain tax-favored and fringe benefits can not be provided--even if they are paid for by the employee with after-tax dollars.

### **Plan Contributions**

Cafeteria plans are usually funded by means of a salary reduction agreement between employer and employee. The employee agrees to accept a reduced salary, with the difference being used to purchase benefits under the cafeteria plan. The employer may contribute to the cost of some benefits. The employee is not taxed on the salary reduction if the salary had not been actually or constructively received at the time of the salary reduction agreement. Thus, the employee's salary reduction goes to acquire plan benefits on a pre-tax basis.

In addition, the employee may be able to use after-tax contributions to supplement the employer contributions and the employee's own pre-tax contributions.

### **Income Taxation of Participants**

When a cafeteria plan benefit is "qualified," that keeps the constructive receipt rule from applying to render the benefit taxable because it could have been taken in cash instead. However, if the participating employee receives group term coverage in excess of \$50,000, the employee will be taxed under the Section 79 rules on the excess coverage.

### **FICA and FUTA Withholding**

If constructive receipt is avoided under the Section 125 rules, the benefits under a cafeteria plan will not be treated as wages subject to FICA and FUTA tax, except that 401(k) plan contributions will be subject to FICA tax.

This benefits the employer as well as the employee since the employer does not have to make matching FICA contributions on the benefits.

### **The Deferred Compensation Prohibition**

Generally, the benefits menu in a cafeteria plan may not include any option that would result in deferral of compensation.

*For example, a cafeteria plan might allow an employee to take extra vacation days, or additional cash compensation. If the employee elects the cash option, the payment must be made before the end of the employee's tax year. If the employee could swap this year's vacation days for cash to be received next year, that would result in a deferral of compensation.*

Similarly, if an employee fails to use all of his or her cafeteria plan elections in a calendar

year, they cannot be carried over to the next year, even if nontaxable benefits are, in fact, elected.

There is an exception to the no-deferred-comp rule for qualified retirement plans that include a 401(k)-type feature. A cafeteria plan may include these as a benefit option.

### **Plan Requirements**

The cafeteria plan must be created by a written plan document that describes:

- eligibility for participation,
- the benefits available,
- period of coverage,
- how the employee elects benefits,
- how contributions are made,
- maximum employer contribution for each participant,
- maximum employee elective contribution (salary reduction), and
- the plan year.

### **Nondiscrimination Rules**

Nondiscrimination rules apply to cafeteria plans to prevent such plans from operating for the disproportionate benefit of highly compensated employees. If a plan fails the nondiscrimination tests, the usually nontaxable benefits of officers, more-than-5% shareholders and highly compensated employees, or spouses and dependents of the foregoing, shall be included in gross income. In fact, the maximum benefit that they could have elected for the year in which discrimination occurs is taxable.

A collectively bargained plan is not subject to the nondiscrimination rules. However, all employees of an affiliated service group or of businesses under common control are viewed as employed by a single employer for purposes of the nondiscrimination tests.

### **Nondiscrimination in Eligibility Safe Harbor**

A cafeteria plan will not be treated as discriminatory with respect to eligibility if the plan meets all of the following safe-harbor requirements:

- It satisfies the nondiscriminatory classification test applicable to qualified retirement plans [IRC Sec. 410(b)(2)(A)(i)].
- It does not require more than three years of service before an employee becomes eligible to participate.
- It prescribes a uniform service requirement for all employees.
- Employees who meet the uniform requirement may commence participation not later than the first day of the first plan year beginning after they satisfy the uniform requirement.

### **Nondiscrimination in Benefits and Contributions Safe Harbor**

Qualified and total benefits under a cafeteria plan cannot discriminate in favor of highly compensated employees. There is a fairly complicated safe-harbor test which assures that benefits and contributions are not provided in a discriminatory manner.

### **Key Employee 25% Concentration Test**

A "key employee" is considered to be in constructive receipt of cash benefit options for any plan year in which the nontaxable benefits provided to key employees exceed 25% of

the nontaxable benefits provided to all employees by the plan. A "key employee" is defined the same as for purposes of the qualified retirement plan top-heavy rules. Excess group term life insurance coverage that is included in gross income is not treated as a nontaxable benefit for purposes of the 25% concentration test.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal, accounting, tax, or other professional advice. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

® Copyright 2002, PWA Insurance Services. All rights reserved.