

## Benefit Fact Sheet

### What is it?

Cafeteria plans are regulated by Section 125 of the Internal Revenue Code (IRC). Cafeteria plans are a valuable employee benefit because they enable employees to receive qualified benefits using pre-tax dollars.

There are three types of Cafeteria plans:

- Premium only plans (POP): The most common type of Cafeteria plan, the POP plans enable employees to withhold a portion of their pre-tax salary to pay for employer-sponsored health and welfare insurance premiums.
- Flexible spending accounts (FSAs)
  - Dependent care FSA ([DCAP](#)): allows participants to pay up to \$5,000 in qualified dependent care expenses using pre-tax dollars.
  - Health care FSA ([FSA](#)): enables participants to fund an individual account to use pre-tax dollars to pay for out-of-pocket healthcare expenses such as deductibles, coinsurance, and services that are not covered under the health insurance plans.
- [Full flex plan](#): Employers can contribute a defined amount for benefits (commonly called credits) and employees can choose which benefits to purchase from a menu of options.

Many employers add Flexible Spending Accounts or a Full Flex plan on top of the core POP plan to provide additional tax-favored benefits.

### Why offer it?

Cafeteria plans are inexpensive to establish and can provide employees with substantial tax savings. The costs of qualified benefits are free from federal and state income taxes as well as from social security withholding, FICA, and workers compensation premiums.

### What types of employers offer it?

Employers of all sizes can offer a cafeteria plan. Most employers offer a POP plan because of the ease of establishing the plan and the tax benefits that are provided. FSAs are popular with all types of employers, while only large employers (1,000+) typically offer full flex plans because of the increased administration and communication requirements.

### What are the critical underwriting or participation requirements?

A cafeteria plan must meet the following IRC eligibility requirements for favorable tax treatment:

- Plan document must be established and a summary plan document (SPD) must be distributed to all participants.
- Plans cannot discriminate on the eligibility and benefits that are provided. Additionally, the plan cannot favor highly compensated or key employees.
- Plan must include two or more benefits consisting of cash and at least one qualified non-taxable benefit.

### What's new in this area?

The Treasury Department has published proposed changes to Section 125 that would become effective January 1, 2009. Among the proposed changes:

- The list of qualified benefits now includes Health Savings Account (HSA) contributions, COBRA premiums, and premiums for individual health insurance.
- The cafeteria plan can lose its tax-favored status if employees are required to participate.

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- Employees can make elections within 30 days of the date of hire and have the benefits become effective retroactive to the date of hire.
- The nondiscrimination testing requirements for cafeteria plans have been clarified.

### Informational link(s)

- [About Cafeteria Plans](#) (DataPath)
- [The Benefits of Cafeteria Plans](#) (Entrepreneur.com)
- [The New Proposed Cafeteria Plan Rules](#) (Thompson HR Special Reports)

### Pros and cons

#### Pros

- Benefits are more affordable for employees because of the tax savings
- Employer's payroll is reduced for purpose of paying FICA taxes and workers compensation premiums
- Plans are inexpensive to set up and are easy to maintain

#### Cons

- Must create a plan document and distribute SPD to all participants
- Tax-free status of plan can be jeopardized if the benefits favor highly-compensated or key employees

### Notes

- **Qualified Benefits permitted in a cafeteria plan:** accident and health insurance premiums, out-of-pocket medical expenses, dependent care expenses, group term life insurance premiums (excluding amounts exceeding \$50,000 and dependent life), elective vacation days, Health Savings Account contributions, 401(k) salary deferrals, taxable cash, and adoption assistance.
- **Qualified Benefits not permitted in a cafeteria plan:** long-term care, medical savings accounts, educational assistance, dependent group term life, coverage for domestic partners who are not federal tax dependents, and any insurance policy that provides a return of premium or paid up option.

This Fact Sheet is designed to provide a general overview of the benefit program, service, or regulatory act it describes. The information included in this document is not a substitute for legal or professional opinion relative to a plan sponsor's particular fact pattern. Your ArlenGroup consultant can answer more specific questions relative to its application for your organization. A menu of additional topics is available online at: [www.arlengroup.com/facts](http://www.arlengroup.com/facts).