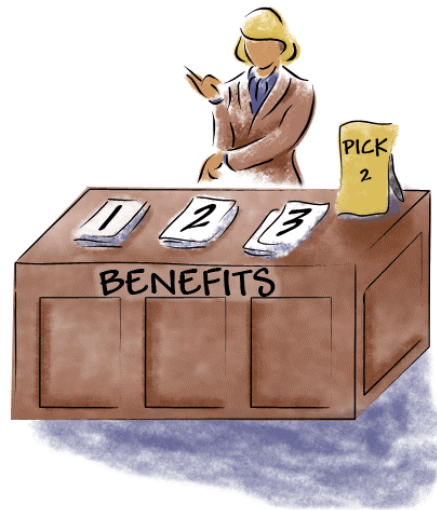


Cafeteria Plans

IRC Sec. 125

Also called flexible benefit plans, cafeteria plans allow participating employees to choose among two or more benefits consisting of cash and qualified benefits. See IRC Sec. 125(d)(1)(B).

There is no need to change current benefit programs. If the employer is unable to pay for fringe benefits, the employee can enter into a salary-reduction agreement with the employer. The employer then uses these funds to pay for the employee's benefits. This allows the employee to pay for his or her own benefits with pre-tax dollars.



Employee Benefits

Some of the benefits that can be enjoyed by employees include the following.

- Lower FICA and income tax withholding due to lower gross pay
- Ability to select those benefits most needed
- Opportunity to refuse benefits already provided by a spouse's employer
- Option of redirecting tax savings to retirement meet retirement needs; e.g., 401(k) plan, life insurance, etc.
- Potential qualification for the earned-income credit due to lower gross income

Employer Benefits

Some of the benefits that can be enjoyed by employers include the following.

- Lower payroll taxes (FICA, FUTA and sometimes worker's compensation insurance) due to lower gross pay
- Sharing cost of benefits with employee, if desired
- Help in retaining key employees
- Improved employee morale due to show of employer concern
- Potential reduction in fringe benefit costs

Continued...

Cafeteria Plans

IRC Sec. 125

Qualified Benefits

Qualified benefits may include:

- Accident and health insurance
- Health Savings Account (HSAs)
- Group term life insurance
- Dependent care assistance
- Cash-or-deferred arrangements
- Adoption assistance

Excluded Benefits

- Scholarships or fellowships described in IRC Sec. 117
- Educational assistance programs described in IRC Sec. 127
- Miscellaneous fringe benefits (including transportation and parking) described in IRC Sec. 132¹
- Nonqualified deferred compensation plans
- Qualified retirement plans, except cash or deferred arrangements under IRC Sec. 401(k)
- Long-term care benefits described in IRC Sec. 4980C and IRC Sec. 7702B
- Contributions to medical savings accounts described in IRC Sec. 220
- Health reimbursement arrangements described in Revenue Ruling 2002-41.

Plan Requirements

The plan must be written and include only employees.² The plan should include the following items.

- Description of benefits and coverage periods
- Eligibility rules for participation
- How benefit elections are to be made
- How employer contributions are to be made; i.e., employer funds or salary reduction
- Maximum amount of employer contributions
- Plan year³

¹ The Transportation Equity Act of 1998 allows pretax contributions for qualifying transit vouchers or parking, but these cannot be part of a cafeteria plan.

² Sole proprietors and partners or subchapter S shareholders who own 2% or more of the business may not participate.

³ See proposed Regulation Sec. 1.125-1, A-3.

Continued...

Cafeteria Plans

IRC Sec. 125

Discrimination

The plan must be available to employees who qualify under a classification established by the employer and which the IRS determines as not discriminating in favor of highly-compensated or key employees.

One discrimination test that impacts greatly on smaller employers is the 25% rule. The benefits or amount deferred by the key employee group may not exceed 25% of the total amount deferred by all employees. If this rule is violated, the deferrals of the key employees are treated as taxable income defeating the purpose of the plan for them. There is no effect on rank and file workers.

Key participants are any participants and participants' beneficiaries who, during the determination year,¹

- are or were an officer of the sponsoring employer and earning more than \$140,000²;
- owned more than 5%³ of the employer; or
- owned more than 1%³ of the employer and received more than \$150,000 of compensation from the employer.

¹ In-service distributions are subject to a five-year look-back period.

² This value applies to 2006.

³ The family attribution rules of IRC Sec. 318 apply. Any participant is deemed to have the same ownership share as his or her spouse, children, parents and grandparents.