

# Cafeteria Plan Description

## Definition:

A cafeteria plan is a written plan under which:

1. All participants are employees
2. The participants may choose between two or more benefits consisting between cash and other qualified benefits

## Advantage:

The advantage for the employer of a fringe benefit cafeteria plan is attracting, motivating, and retaining quality employees. Additionally, the employer can fix the benefit cost for all employees.

## Employee Tax Advantage:

The employee tax advantage is a salary reduction allocated to non-taxable benefits, which are not subject to FICA taxes. Salary reduction allocations to non-taxable benefits are not included in gross income; therefore there is a result of tax savings.

## Employer Tax Advantage:

Salary reductions allocated to non-taxable benefits are not subject to the employer FICA or FUTA taxes.

## Disadvantages:

The two disadvantages are the “use it or lose it” principle: any allocated moneys not used within a year must be forfeited. Secondly, the internal and external administrative expenses associated with the cafeteria plan must be considered in regards to the tax savings. The proper plan design and employee education will minimize the “use it or lose it” principle and create significant tax savings.

## Section 125 Tax Law:

Section 125 tax law imposes the following requirements, which must be considered in the design of the cafeteria plan:

1. Limitations on who can participate
2. Limits on how and when choices can be made and changed
3. Limits on what benefits can be included
4. Limits on discrimination and favor of highly compensated employees
5. Record keeping and disclosure requirements

## How the Choice of Benefits is Made:

By definition, a cafeteria plan must permit the employee to choose between two or more benefits. The choice of benefits must be made prior to the start of the year and generally cannot be changed. The employer can provide a given amount of money to utilize in the purchase of benefits, which is not a salary deduction for the employee. Additionally, the plan may provide that the employee choices be made through salary reduction where the employees agree to reduce their compensation in exchange for purchasing non-taxable benefits under

the plan. If the employee elects to allocate compensation to the purchase of a benefit the allocated amount is forfeited if the employee does not actually use the benefit.

## Circumstances Permitting a Change in Election:

The following circumstances will permit the employee to revoke an existing election of benefits and make a new one within a single plan year:

1. Marriage or divorce
2. Death of a spouse or a child
3. Birth or adoption of a child
4. Termination or commencement of employment of a spouse
5. Switching from full time to part time employment by the employee or the employee's spouse
6. Switching from part time to full time employment by the employee or employee's spouse
7. Court order change in coverage, such as ERISA qualified medical support order
8. Employee's spouse or dependent becomes eligible for Medicare or Medicaid coverage
9. Taking unpaid leave of absence by the employee or employee's spouse
10. A significant change in the health coverage of the employee or the employee's spouse attributable to a spouse's employment
11. A significant change in the cost or coverage offered by an independent third part provider of health care under the plan

## Permitted Benefits

1. Cash – this is the only taxable benefit
2. Health and accident insurance
3. Dental insurance
4. Eye care
5. Long-term care coverage
6. Disability insurance
7. Group term life insurance
8. Medical reimbursement for non-insured benefits under Section 105
9. Dependent care assisted payments
10. Elective contributions under Section 401(k) Plan
11. Elective paid vacation days

## Plans Cannot Discriminate:

A properly designed cafeteria plan must meet non-discriminatory testing standards. Annually, the plan must have discrimination testing as well as the appropriate reporting to the Internal Revenue Service.

## Direct all correspondence to:

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