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To flex or not to flex? That is the question. Key details to consider when deciding if a cafeteria plan is right for your business.

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One of the key decisions employers make about employee benefits offerings is whether to provide the benefits through a cafeteria plan, also known as a "flexible benefit" or "flex" plan.

Using a cafeteria plan can have tax advantages for both employers and employees because salary reductions to pay for the benefits are not subject to tax. However, this tax-free option has other consequences, including a number of compliance requirements, and in some cases, it can have an effect on whether benefits paid to the employee are taxed later on.

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This article may be of interest to employers of all sizes and explores the issues related to cafeteria plans, focusing on supplemental benefits (also called "excepted benefits") such as critical illness coverage, hospital indemnity and other fixed indemnity health coverage, specified disease coverage and disability coverage. These insurance policies are supplemental benefits because they are not primary medical coverage or a substitute for major medical insurance.

What is a cafeteria plan?

When many employers hear the term "cafeteria plan," they may think of arrangements with employer credits and complicated administration requirements. In actuality, these plans are more prevalent than many may think. For federal tax purposes, a cafeteria plan is any employer-sponsored arrangement that allows employees to pay for certain types of benefits on a pretax basis through salary reduction.

As the name "flex" suggests, cafeteria plans can provide considerable flexibility to employers when designing a plan and to employees when choosing from the benefits offered under the plan. With respect to supplemental benefits, a common plan design is a Premium-Only Plan (POP), through which employees pay for the premium through pretax salary reduction. The key advantage of using a cafeteria plan is that the amount of salary reduction used to pay for qualifying benefits is excluded from the employee's taxable income for federal tax purposes. The salary reduction amount is also excluded from wages for purposes of both the employer and employee shares of payroll taxes, including those from Social Security, Medicare, the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA). Additionally, some employers use a cafeteria plan to offer more expansive benefits, including such things as health and dependent care spending accounts.

These plans are governed by section 125 of the Internal Revenue Code and for this reason are also sometimes referred to as "section 125 plans." Section 125 imposes a number of different compliance requirements, such as a written plan document and irrevocable elections, in exchange for this favorable tax treatment. Many states, excluding New Jersey and Puerto Rico, provide similar tax benefits as the federal tax rules.

What are the tax consequences of using a cafeteria plan to pay for supplemental benefits?

Cafeteria plans offer tax savings on the front end, because premiums for supplemental benefit policies can be paid on a pretax basis. However, in some cases, pretax premiums can have an effect on taxation on the back end when benefits are paid. The rules vary based on the particular coverage, so the charts below provide a summary of tax consequences when premiums for supplemental coverage are paid pretax and after-tax.

Tax rules for fixed indemnity health supplemental products

These policies pay benefits on a cash basis in a fixed dollar amount upon the occurrence of a covered medical event as specified in the policy (e.g., a hospital stay or a diagnosis of a particular illness and treatments for such illness), rather than directly reimburse medical expenses.

Hospital Indemnity, Other Fixed Indemnity Health, and Specified Disease or Critical Illness Policies		
If premiums are paid …	**Then, the premiums are …**	**And the benefits are …**
Pretax, either through employee salary reduction or direct employer contributions.	Excluded from the employee's income and wages for both the employer and employee share of payroll taxes (e.g., FICA, FUTA).	Excluded from the employee's gross income up to the amount of the related unreimbursed medical expenses. "Excess benefits," meaning the amount of benefits that exceed related unreimbursed medical expenses, are taxable income. The employee is responsible for determining the amount of any taxable benefits and including this amount on their personal income tax return.
After-tax.	Included in the employee's income and wages for both the employer and employee share of payroll taxes (e.g., FICA, FUTA).	Excluded from the employee's income.

For more information on the taxation of fixed indemnity health benefits paid for on a pretax basis, see https://www.aflac.com/business/resources/advisories/clearing-the-air-again-on-taxation-of-fixed-indemnity-health-benefits.aspx.

Tax rules for disability benefits

The tax treatment of disability benefits (including most accident and sickness disability) are somewhat different compared to the rules for fixed indemnity health benefits.

Disability Benefits (Including most accident and sickness disability)		
If premiums are paid …	**Then the premiums are …**	**And the benefits are …**
Pretax, either through employee salary reduction or direct employer contributions.	Excluded from the employee's income and wages for both the employer and employee share of payroll taxes (e.g., FICA, FUTA).	Fully included in the employee's gross income. Also, the first six months of sick pay are included as wages for FICA purposes.
After-tax.	Included in the employee's gross income and wages for both the employer and employee share of payroll taxes (e.g., FICA, FUTA).	Excluded from the employee's income and wages.

What are key compliance issues for a cafeteria plan?

1. **There must be a written plan document.** The plan document must contain details regarding the plan, including a description of the benefits offered, eligibility rules, how to make contributions, the maximum allowable contribution (either a specific amount or a formula), a description of the plan year, and rules regarding timing of and permitted changes in elections.

2. **Only common-law employees can participate.** Any type of employer can sponsor a cafeteria plan, including corporations, partnerships, sole proprietors, limited liability entities and governmental employers. However, subject to very limited exceptions, only common-law employees of the employer can participate in the cafeteria plan. Self-employed individuals (sole proprietors), partners, independent contractors and more than 2% shareholders of S corporations cannot participate in a cafeteria plan. For example, although a partnership can sponsor a cafeteria plan for its common-law employees, the partners themselves cannot participate in the plan.

3. **Only qualified benefits may be offered.** A cafeteria plan must provide employees the choice between cash (e.g., regular compensation) and qualified benefits. Qualified benefits include coverage under the employer's group health plan. Employees can use a cafeteria plan to pay for individual health and disability insurance policies where premiums are list billed by the employer. Other common types

of qualified benefits include health flexible spending arrangements or accounts (FSAs), dependent care (including dependent care FSAs) and contributions to health savings accounts (HSAs). Additional requirements may apply, depending on the type of benefits offered.

4. **The plan must have a plan year**. The written plan document must specify the plan year. The plan year is the "coverage period" for benefits offered under the plan and is important for benefits election timing purposes, as well as various administrative requirements applicable to the plan. In general, the plan year must be a 12-month period. A plan year of less than 12 months is permitted for a valid business reason, such as starting a new plan in the middle of a plan year.

5. **Participant elections must be made before the beginning of the plan year and, subject to limited exceptions, cannot be changed during the plan year**. Cafeteria plan rules limit the circumstances in which participants may make changes to elections during the plan year. The plan does not have to allow changes in all these circumstances. The written plan document must describe what changes are allowable. Additionally, the employer or other plan administrator is responsible for ensuring compliance with the election rules (for instance, determining if the particular change is permissible and if it is consistent with the reason for the change).

Common circumstances in which mid-year election changes are allowable include:

- ✔ Change in family status (e.g., marital status).
- ✔ Change in employment status that impacts eligibility.
- ✔ Change in cost or coverage options.
- ✔ Employee leave related to the Family Medical Leave Act (FMLA).

Note: Absent an event that triggers a permitted change, employees cannot make election changes mid-year. For example, an employee cannot stop salary reduction contributions mid-year merely because the employee decides they don't want the coverage. There must be a permitted triggering event and stopping the salary reduction must be consistent with that event.

6. **Nondiscrimination rules apply**. Cafeteria plans are subject to specific nondiscrimination rules designed to prevent discrimination in favor of "highly compensated employees" with regard to eligibility to participate in the plan and benefits provided under the plan. In addition, nontaxable benefits provided to "key employees" participating in the plan may not exceed 25% of nontaxable benefits provided to all participants. If a plan fails the nondiscrimination tests, then the salary reduction amounts for highly compensated employees or key employees are included in gross income.

7. **Application of ERISA**. Most benefits offered by private employers to employees through a cafeteria plan are subject to the Employee Retirement Income Security Act of 1974 (ERISA). For more information on the requirements for the voluntary safe harbor under ERISA as applied to supplemental benefits, see aflac.com/business/resources/advisories/voluntary-plans-erisa.aspx.

Conclusion

Cafeteria plans can provide flexibility to employers and employees, as well as welcome tax savings. Many employers use cafeteria plans to allow employees to pay for supplemental coverage on a pretax basis, often along with offering other types of qualified benefits. Still, using a cafeteria plan model carries additional administrative and compliance issues. In addition, pretax payment of supplemental benefits premiums can have an effect on the employee's taxes on the back end. Employers should consult their own tax and benefits plan consultants to determine what is right for them.

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