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Cafeteria Plan Benefits: A Primer for Employers

As employee benefits continue their upward trend, the need for cafeteria plans is more urgent than ever.

According to a 2019 survey by the Society for Human Resource Management, *"Employers were more likely to increase offerings in all benefits categories than to decrease offerings."* Further, employers believe that healthcare benefits are the most important to their workforce.

However, healthcare benefits have a long-standing reputation for being pricey. To alleviate the cost burden for employees, in 1978, the U.S. Congress created Section 125 of the Internal Revenue Code. Benefit plans established under Code Section 125 are known as cafeteria — or Section 125 — plans.

How Cafeteria Plans Work

A cafeteria plan enables employees to pay for qualified benefits, such as group health insurance, on a pretax basis.

Paying for benefits with pretax dollars means that the benefits are withheld from the employee's wages before taxes are taken out — thereby lowering the employee's and employer's tax liability.

To deliver benefits on a pretax basis, the cafeteria plan must meet the conditions of Code Section 125.

Key Requirements of Section 125

- The cafeteria plan must maintain a written plan document that includes a description of benefits provided under the plan, eligibility requirements, how elections can be made, employer contribution guidelines, and the plan year.
- Only common-law employees can participate in the plan on a pretax basis.
- Elections normally cannot be revoked or modified during the plan year — unless the change is permitted under Internal Revenue Service (IRS) rules, such as a change in marital status.
- The plan must offer employees a choice between at least one taxable benefit (e.g., cash in the form of wages) and at least one qualified nontaxable benefit.

- Typically, the plan must pass certain tests — including an eligibility test and a key employee concentration test — to ensure it does not discriminate in favor of highly compensated employees. Small employers, however, can adopt a "simple cafeteria plan," which is treated as satisfying nondiscrimination rules so long as eligibility, participation, and minimum contribution requirements are met.

Some states have adopted cafeteria plan laws as part of their healthcare reform. So, consult state law for standards that may apply to your business.

Permitted Benefits

Only "qualified benefits" — as defined by law — are allowed in a cafeteria plan. They include:

- Group health plans
- Dental and vision plans
- Group-term life insurance
- Disability insurance
- Adoption assistance
- Dependent care assistance
- Health savings accounts
- Health flexible spending accounts
- Health reimbursement arrangements
- Accidental death and dismemberment coverage
- 401(k) deferrals
- Cash or other taxable benefits

Benefits that *cannot* be provided through a cafeteria plan include educational assistance and transportation (commuting) benefits.

Tax Advantages and Implications

Most benefits offered under a cafeteria plan are excluded from federal income tax, Social Security tax, Medicare tax, and federal unemployment (FUTA) tax. But there are exceptions:

- Group-term life insurance coverage over $50,000 is subject to Social Security and Medicare taxes, but not federal income tax withholding or FUTA tax.

- Adoption assistance benefits and 401(k) deferrals are subject to Social Security tax, Medicare tax, and FUTA tax, but not federal income tax withholding.

- Some benefits, such as dependent care assistance, have a yearly pretax contribution cap. Anything over the annual limit is taxable.

If a benefit is not taxable, it should be subtracted from the employee's gross wages before the respective taxes are withheld. This process lowers the employee's taxable wages and tax liability plus your share of applicable taxes.

Conversely, if the benefit is taxable, it should be subtracted after taxes are withheld. This process does *not* reduce taxable wages or tax liability.

Cafeteria plan benefits are often excluded from state and local payroll taxes. But not all states and localities are on board with this exclusion. For example, in New Jersey, cafeteria plan benefits are generally subject to state income tax.

Check with your state or local taxation agency to determine whether cafeteria plan benefits should be deducted before or after withholding state or local taxes.

Other Laws Impacting Cafeteria Plans

Along with obeying Code Section 125, a cafeteria plan may need to comply with:

- The Employee Retirement Income Security Act (ERISA)
- The Affordable Care Act (ACA)
- The Consolidated Omnibus Budget Reconciliation Act (COBRA)
- The Health Insurance Portability and Accountability Act (HIPAA)
- The Genetic Information Nondiscrimination Act (GINA)
- Federal and state discrimination laws
- Federal and state wage and hour laws
- IRS reporting rules

Conclusion

Cafeteria plans can be quite challenging to design, establish, administer and maintain. They also cost money to set up. But for many employers, these inconveniences are offset by tax savings plus a competitive edge that strengthens talent attraction and retention.