Benefits Insights

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Section 125 Plans (Cafeteria Plans)

Many employers struggle with the challenge of providing an attractive compensation package at an affordable price. One tool available to meet this challenge is the Section 125 plan. Section 125 plans are also commonly referred to as cafeteria plans. While there are different types of Section 125 plans, each provides the opportunity to save money by reducing both the employer's and employees' tax liability. This article will outline for you the basics of offering a Section 125 plan.

What is a Section 125 plan?

A Section 125 plan may be established pursuant to rules found in the Internal Revenue Code (IRC) Section 125. This IRC provision provides an exception to what is generally called the "constructive receipt doctrine." Under the constructive receipt doctrine, offering an employee a choice between cash and an employee benefit requires that the amount that could have been received be included in the employee's gross income.

A Section 125 plan allows employers to provide their employees with a choice between cash and certain qualified benefits without adverse tax consequences. Without a Section 125 plan, employee contributions can only be made with after tax dollars.

What are the different forms of Section 125 plans?

The three basic forms of Section 125 plans are:

- Premium Only Plan;
- Flexible Spending Account; and
- Full Cafeteria Plan.

What is a Premium Only Plan?

The Premium Only Plan is the most basic type of Section 125 plan and the most popular. A Premium Only Plan allows employees to pay their portion of insurance premiums with pre-tax dollars, which in turn reduces both the employer's and employees' tax liability. Benefits that are typically offered within a Premium Only Plan include: health, dental, vision, accidental death and dismemberment and group term life insurance.

What is a Flexible Spending Account?

Under IRC Section 125, employees may make pre-tax contributions to a Flexible Spending Account. An employee may seek reimbursement from the Flexible Spending Account for expenses paid for child care, health plan deductibles and eligible medical expenses not otherwise covered under a health plan. A Flexible Spending Account allows an employee to increase his or her spendable income while also reducing the employer's tax liability.

What is a Full Cafeteria Plan?

Under a Full Cafeteria Plan, the employer makes a non-elective contribution for every eligible employee. The employees may spend the employer contribution to purchase any of the benefits offered within the plan. In addition, the employee may contribute pre-tax dollars to purchase additional benefits beyond what he or she can purchase with the employer's contribution.

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Can an employer offer its employees a choice between cash and benefits?

Yes, an employer may offer a cash-out option through its Section 125 plan. For example, an employer may offer $500 to employees who do not elect benefits. Because an employee who waives coverage in exchange for the $500 payment can later elect coverage following a qualifying event, employers may want to pay the cash-out in equal installments throughout the plan year.

What are the disadvantages of offering a Section 125 plan?

For an employee, the disadvantages of participating in a Section 125 plan include:

- An employee may not change his or her elections during the plan year unless he or she experiences a permitted election change event (for example, birth of a child or marriage).
- Any unused funds remaining within a Flexible Spending Account at the end of the plan year and any applicable grace period are lost. However, employers also have the option of allowing employees to carry over up to $500 of unused funds from one year to the next.
- While a Section 125 plan reduces the employee's taxable income, it also may reduce other benefits. Benefits that are calculated using the employee's income (for example, Social Security or retirement benefits) will, in turn, be reduced.

For an employer, the disadvantages of offering a Section 125 plan include:

- While the employer reduces its tax liability, it is responsible for the cost, establishment and maintenance of the plan.
- Employers offering a health Flexible Spending Account bear some risk of loss. The uniform coverage rule requires that the full amount elected by the employee (minus any reimbursements already paid) be made available to the employee at any time during the plan year.

Example: An employee elects to contribute $2,400 to a Flexible Spending Account for the plan year. The employee contributes $200 each month. On January 15, the employee submits a $2,400 receipt for his corrective eye surgery performed a week earlier. The employee is entitled to reimbursement of $2,400. Ten days later, the employee terminates his employment. The employer is not entitled to recover from the employee the balance owed to the Flexible Spending Account for the plan year. For this reason, some employers limit the amount an employee can contribute to the Flexible Spending Account.

What special rules apply to small employers that want to sponsor Section 125 plans?

Effective in 2011, the Affordable Care Act created Simple Cafeteria Plans to ease the small employer's administrative burden of sponsoring a cafeteria plan. A Simple Cafeteria Plan is a cafeteria plan established by a small employer that meets certain contribution, eligibility and participation requirements. By meeting these requirements, the cafeteria plan will be treated as satisfying the nondiscrimination rules applicable to cafeteria plans. For this purpose, a small employer is one that employed an average of 100 or fewer employees during either of the two preceding years.