

## INTRODUCTION TO EMPLOYEE CAFETERIA PLANS

There are three types of tax-qualified plans under Section 125 of the Internal Revenue Code: *premium conversions plans*, *flexible spending accounts* and *full-flex plans*. These plans are commonly referred to as “cafeteria plans.” The two most popular types of pre-tax cafeteria plans are premium conversion plans and flexible spending accounts. There also are full-flex plans which offer true cafeteria-style choices, that may include multiple health plan options, along with different levels of life and disability insurance coverages. All three plans allow contributions and deposits to flexible spending accounts to be made with pre-tax dollars. Cafeteria plans are a benefit to employers because deductions are made from an employee’s pay pre-tax; thus employers do not pay FICA, Medicare, or FUTA taxes on that portion of the employee’s pay.

Premium conversion plans allow employees to pay their share of premiums for health coverage, life insurance and other qualified benefits such as disability insurance on a pre-tax basis. This normally is done through payroll deduction. Employees must elect to convert otherwise taxable income to pre-tax contributions prior to the beginning of the plan year.

There are two types of flexible spending accounts (FSA). The Health FSA is for expenses that are not covered by insurance, such as deductibles, co-pays, co-insurance amounts and non-covered items such as dental or vision expenses. The Dependent Care FSA is for qualifying child care expenses. With both of these accounts, the employee elects to transfer a certain amount of money tax-free from each pay into his/her account. Plan sponsors (employers) may set a limit on contributions to a Health FSA, whereas contributions to a Dependent Care FSA are limited by law to no more than \$5,000 annually. When expenses that qualify for reimbursement occur, the employee submits a claim to his/her FSA account and the amount is paid without being subjected to taxes. We note that the employer assumes an administrative role in the processing of FSA claims.

With regard to a Health FSA, the employer must have available, at the start of the plan year, the full amount elected by the employee for the plan year available to reimburse an employee’s medical expenses. This is known as the “uniform reimbursement” rule. Unfortunately, the uniform reimbursement rule can have an adverse economic effect on an employer if an employee who is enrolled in a Health FSA incurs and is reimbursed expenses, and then quits before contributing the full amount for which they have already been reimbursed. Note that the uniform reimbursement rule does not apply to a Dependent Care FSA.

Under both a Health FSA and a Dependent Care FSA, the elected amount cannot be changed during the plan year unless the employee experiences a “change in status” and the plan permits the change. Examples of changes in status are birth, death of a dependent, marriage and divorce. Further, under both a Health FSA and a Dependent Care FSA, employees may not carry-over unused funds from one year to the next year. This is known as the “use it or lose it” rule. At the end of the plan year, unused contributions are forfeited by the employee to the plan.

Employers must be aware that a written plan must be created to legally create a cafeteria plan. The written plan must include a specific description of each benefit available under the plan and the period of coverage. The written plan also must include the following:

- 1) Rules governing which employees are eligible to participate in the plan.
- 2) The procedures for making elections under the plan, including when elections may be made, the rules governing irrevocability of elections and the periods for which elections are effective.
- 3) The manner in which employer contributions may be made such as by salary reduction agreement between the employer and the employee, by non-elective contributions or by both.
- 4) The maximum amount of employer contributions to any participant.

It is important to note that each cafeteria plan must file an annual informational report (Form 5500) with the IRS.

If your school district is considering implementing a cafeteria plan, we suggest that more specific advice be sought from a tax expert. Furthermore, as this is an additional fringe benefit, be aware that the district may have a duty to bargain over its implementation with the union representing the respective employees. Finally, the U.S. Department of Health and Human Services recently announced that Flexible Spending Accounts and cafeteria plans are not excluded from the definition of health plan and are therefore covered by HIPPA's privacy and related rules as health plans. Accordingly, there may be additional HIPPA implications related to cafeteria plans.

Clients who have questions regarding issues discussed in this article, or any education law matter, should feel free to call us at 215-345-9111.