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Benefiting Cities: How Cafeteria Plans Enhance City Benefits while Saving Taxpayer Money

Our economy is facing some significant turbulence — the housing market is on the downswing, inflation is rising, and some businesses are facing hard times. This all adds up to an even harder time for cities that face these same challenges, but are seeing falling tax revenues.

Raising taxes is not a good option. Flippant efficiency experts may recommend “working smarter,” but retaining good employees while cutting costs is difficult if not impossible. Increasingly, employees define a “good job” by the benefits their employer offers. Yet in these lean years it may be difficult to expand city employees’ package of benefits.

Thus it may be the time for city leaders to examine whether or not their city is taking full advantage of Section 125 (or “cafeteria”) plans. Cafeteria plans allow employers to expand their benefit offerings to their employees, increase their take home pay, and may even lower their state and federal tax burden. Despite these advantages, the Employee Benefit Research Institute once reported only 8 percent of all employees participate in a cafeteria plan. With many cities facing a tight budget year and with property values falling, it has rarely been more important to find ways to cut costs *and* retain good employees.

What Is a Cafeteria (Section 125) Plan? As its name implies, cafeteria plans give city employees choices. In its simplest form, cafeteria plans allow employees to trade their wages for benefits on a pretax basis. Employers agree to deduct the cost of these benefits from employees’ pay. Employers then either give the money directly to the benefit provider (e.g., an insurance company) or deposit it into the employee’s account. Possible options include:

- *Accident and health insurance* — Most commonly, employees are allowed to choose whether or not they will participate in any employer group health plan. Those participating in the plan may have their share of the premiums deducted from their wages on a pretax basis.
- *Individual accident and health insurance* — A recently promulgated IRS rule also allows individual (i.e., non-group) health insurance premiums to be de-

ducted on a pretax basis. However, some states define these pretax contributions as group insurance, so employers may want to check with their state department of insurance.

- *Flexible Spending Accounts (FSA)* — Employees may elect to contribute on a pretax basis to an FSA that will cover their unreimbursed medical expenses. Expenses may include uncovered items like glasses or contact lenses, or may reimburse them for the cost of their health plan deductible. Similar to other accounts, all unused funds are lost at the end of the year (i.e., the money reverts back to the employer).
- *Adoption assistance* — Employees are allowed to contribute up to \$10,000 on a pretax basis into a segregated account to cover qualified adoption expenses for either domestic or foreign adoptions. Any money left in the account at year’s end is lost.
- *Dependent care assistance* — Employees are allowed to contribute up to \$5,000 on a pretax basis into a segregated account to cover qualified dependent care expenses, though only one parent is allowed to contribute on a pretax basis. Similar to adoption assistance, any unused money is lost at the end of the year.
- *Group term life insurance* — Employees who elect to receive group term life insurance are allowed to pay for the premiums on a pretax basis if the face amount of the policy is less than \$50,000.

Employees Benefit. Cafeteria plans allow a unique win-win situation for cities and their employees. The city is able to offer a wide variety of fringe benefits that most large businesses may not even offer, such as adoption assistance. Employees can choose benefits that may be extremely valuable to *them*, but may not be of value to others. Most importantly, the plans can positively impact the take home pay for employees, and lower the tax burden for the city. In its “FAQs for Government Entities Regarding Cafeteria Plans,” the IRS states:

Employer contributions to the cafeteria plan are usually made pursuant to salary reduction agreements between the

employer and the employee in which the employee agrees to contribute a portion of his or her salary on a pre-tax basis to pay for the qualified benefits. Salary reduction contributions are not actually or constructively received by the participant. Therefore, those contributions are not considered wages for federal income tax purposes. In addition, those sums generally are not subject to FICA and FUTA.

In plain English, cafeteria plans allow employee benefits to be paid on a pretax basis, which reduces an employee's income for tax purposes. This in turn lowers the employee's federal, state and payroll (i.e., Social Security and Medicare) tax liabilities. The employee's net take-home pay increases because (in the absence of a cafeteria plan) these expenses would have been paid after taxes.

Employers Benefit. The biggest advantage to a city is the expansion of its benefit program without any actual cost to the city. By offering an attractive menu of benefits, employee retention will likely increase.

Cities may also gain financially. By deducting the cost of benefits on a pretax basis, an employee's wages are effectively reduced — including Social Security and Medicare contributions. This reduced taxable income saves the city its matching FICA (payroll) taxes as well as any FUTA (unemployment taxes).

Cafeteria Plan Requirements. The IRS actually imposes few requirements on city employers wishing to establish cafeteria plans. It has created a separate frequently-asked-questions section for government entities (<http://www.irs.gov/govt/fslg/article/0,,id=112720,00.html>).

In that section, the IRS states:

Is there a filing requirement for a cafeteria plan?

Generally, no. If you only have a cafeteria plan, you are not required to file Form 5500 or Schedule F. However, if you have a welfare benefit plan, you may be required under Department of Labor regulations to file a return for that plan. Please see the Form 5500 Instructions or contact the U.S. Department of Labor for more information.

Other requirements imposed on the city are more general. For example, employers are required to offer the range of benefits on a nondiscriminatory basis. Employees can

choose among their benefit options, or choose cash (i.e., their wages).

Conclusion. Taking full advantage of the city's cafeteria plan can benefit the city and its employees. Raising employees' net income while reducing city expenses maximizes the city's use of taxpayer dollars and the value of each city job.

For More Information

If city managers have a benefit administrator, third-party administrator for their self-funded plan, or have hired a payroll service, they may be able to provide more information. In addition, the Internet has a number of good resources available:

From the IRS:

FAQs for Government Entities Regarding Cafeteria Plans:

<http://www.irs.gov/govt/fslg/article/0,,id=112720,00.html>

Employer's Tax Guide to Fringe Benefits

<http://www.irs.gov/pub/irs-pdf/p15b.pdf>

Proposed IRS Cafeteria Rules

<http://edocket.access.gpo.gov/2007/pdf/E7-14827.pdf>

Other entities:

A Guide to Cafeteria Plans:

<http://www.eflexgroup.com/downloads/homepage/joyner.pdf>

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