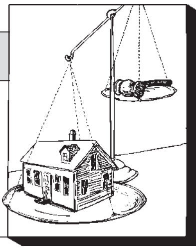
THE LEGAL COLUMN



"Cafeteria" Plans Offer Flexible Benefits

by Dawn Zammitti

A "cafeteria" benefit plan is one in which employees can choose between cash compensation or a number of nontaxable benefits. The benefits can include such things as health and accident plans, group term life insurance, legal service plans, paid vacation days, and certain other qualified benefits. These plans can provide tax savings to both employees and employers.

The main advantage of these plans is that they let you compensate employees with something other than salary. Money spent to buy benefits is not subject to income tax or FICA, as salary is. Both employer and employee thus save tax money.

These plans also let employees tailor their benefit packages to their particular needs. Not all employees need a given type of benefit (such as life insurance) or the same level of a given benefit. Choosing the ones they need at the levels they need makes the benefit system more efficient and economical. It also helps in hiring and retaining employees.

How Are Cafeteria Plans Administered?

Most cafeteria plans are flexible spending accounts that are funded with the salary deductions of employees. The plans have to be set up by a tax lawyer or tax accountant, which usually costs $500 to $1,500. Administering these plans in-house is not too difficult, but you may choose to use a payroll service to administer the plan, for which you'll be charged a modest administrative fee. The only extra tax documentation required is the filing of a Form 5500 with the IRS every year.

Generally, the fewer options you offer, the lower the cost. Small companies should survey their employees so that only the most popular benefits end up on the menu. The most cost-efficient will be those that everyone wants to use.

Each year, each employee chooses which benefits he or she wants, and at what level. The employee's payroll deduction is set accordingly. The various employees' contributions are pooled into accounts to pay for each benefit type — for example, one account for health insurance, another for life insurance, and so on. If qualified expenses are involved (such as reimbursement of medical expenses), these accounts pay those as well. Once an employee elects a given benefit, he or she cannot change it during the plan year unless there is a change in family status, such as divorce, marriage, or the birth of a child.

The Premium-Only Option

In general, cafeteria plans work best for companies offering several types of benefits. If the only benefit you carry is health insurance partly funded by your employees, however, one type of cafeteria plan, called a *premium-only plan*, can still offer savings.

A premium-only plan saves your employees from being taxed on their contribution toward health insurance premiums. It can be one way to offer optional health insurance at less cost to the workers than paying an equivalent portion of their premiums outright to another carrier. The employee's share of the premium is withheld from payroll, and the employee is therefore not taxed on that portion of salary. For instance, if an employee making $24,000 a year contributes $1,000 in payroll deductions toward the health insurance premiums, his or her taxable income will be only $23,000.

There's one glitch to watch for in these plans: Effective this year, some employees with income below a certain level (approximately $22,000) may qualify for a refundable supplemental earned-income tax credit for their payments of qualified health insurance premiums. But premiums paid on a pre-tax basis through payroll deductions are not qualified for this credit. Therefore, if an employee qualifies for this credit, he or she should compare the tax advantages of using the credit versus participating in the premium-only plan. Obviously you, as employer, would not want to require participation in premium-only plans if you have employees in that income bracket.

Is This for You?

If your company's employees already pay a portion of the company's group health insurance premium, a premium-only cafeteria plan will provide tax savings to the employees. If you are already offering, or wish to offer, other benefits as well, a cafeteria plan can provide a way to increase your employees' total compensation without increasing either your own payroll taxes or the employees' income tax bills. A qualified tax attorney or accountant can help you explore these options. ■

Dawn Zammitti is an attorney with Robinson & Cole, of Hartford, and Stamford, Conn.