

## "CAFETERIA" PLANS: Providing Value For Both Employers and Employees

Generally, the mere *availability* of cash as a choice instead of certain benefits, raises the legal presumption that the employee actually *received* the cash (for employment tax purposes) even where actual receipt may not have occurred. Normally, "cash" received from an employer is taxable. So, by simply providing an exception to the constructive receipt rule, Section 125 of the Internal Revenue Code enables employees to select combinations of benefits within an employer's plan, without sacrificing the tax-favored status of any benefit.

Therefore, if the employee chooses qualified (tax-exempt) benefits within a Section 125 plan, federal income tax withholding, and social security, Medicare and FUTA taxes generally do not apply to the chosen benefits, even though the employee could have selected cash. Of course, if cash is actually chosen instead of benefits, federal income tax withholding, and social security, Medicare and FUTA taxes will apply as they would to ordinary wage payments. Importantly, if a benefit is taxable outside a Section 125 plan, it continues to be taxable when provided under the plan.

The term "cafeteria plan" refers to a plan established under Code Section 125. The phrase describes an employer plan which provides employees a "menu" type of benefits choice, offering two or more benefits including cash and certain tax-preferred (non-taxable) benefits. Therefore, some people use the terms "cafeteria plan" and "Section 125 plan" interchangeably. Without a cafeteria plan, employees who pay for benefits such as medical and dental insurance, must do so on an after-tax basis.

### I.R.S. Requirements

Section 125 specifies requirements for cafeteria plans: written documentation, certain reporting to the I.R.S., and limits on the frequency of employee changes to benefit elections. Particularly important, the tax preference of Section 125 will not apply to any benefit provided under the plan if the plan discriminates in favor of "key" or "highly-compensated" individuals as to eligibility to participate, or as to contributions and benefits. In cases of discrimination, the benefits selected by such "key" and "highly-compensated" employees will lose the tax exclusion.

Employers often offer a formal cafeteria plan under Section 125 as the "core" within a broader range of benefit choices. Of course, any taxable benefits outside the formal Section 125 plan must be purchased with employee after-tax contributions or, if provided free to the employee, be recognized as taxable income.

### What Benefits May Be Included?

Section 125 requires that the employee's selection be from among two or more benefits consisting of "qualified" benefits (that is, tax-exempt benefits) and cash. Both a cash benefit and at least one tax-exempt benefit must be offered. Therefore, Section 125 would not apply to a plan offering a choice between two or more non-taxable benefits, but *no* cash benefit alternative.

Employer-provided benefits permitted by Section 125 for a cafeteria plan are the following:

- Accident and health insurance plans,
- Group-term life insurance,
- Dependent care assistance,
- Elective contributions to a 401(k) plan,
- Elective vacation days, and

- Flexible spending accounts (health care, adoption assistance and dependent care reimbursement)

Note that the exclusion from gross income of group-term life insurance premiums paid by the employer applies only to coverage up to and including \$50,000. However, employers may include GTL coverage in excess of \$50,000 as an option in a flexible benefits plan, even though federal income tax, and social security, Medicare and FUTA taxes apply to the cost of the excess amount of coverage. Importantly, however, employers are not required to *withhold* Federal income tax on such amounts, even though at year end the benefit will be taxable for the employee's calculation of Form 1040 tax liability.

Finally, social security, Medicare and FUTA taxes apply to elective deferrals under a Section 401(k) plan, even though federal income tax withholding does not apply.

### What Benefits May Not Be Included?

Benefits prohibited from being included in a cafeteria plan include:

- Scholarships, fellowships and tuition reduction;
- Van pooling arrangements;
- Fringe benefits which qualify as no-additional-cost services, qualified employee discounts, working condition fringes, de minimis fringes, qualified transportation fringes or qualified moving expense reimbursements;
- Meals and lodging furnished for the convenience of the employer;
- Deferred compensation arrangements (other than a Section 401(k) plan).

### Deferring Receipt of Compensation

A cafeteria plan may not include any benefit that defers the receipt of compensation to another year, except for contributions to a Section 401(k) plan. A cafeteria plan would violate this restriction if it permitted participants to carry over unused elective contributions or benefits from one plan year to another. Likewise, contributions for one plan year may not be used to purchase a benefit that will be provided in a subsequent plan year. For example, any type of disability or long-term care plan, or insurance coverage with a savings or investment feature, such as whole-life insurance, may not be included in a cafeteria plan. In the same way, a cafeteria plan may not include a health expense flexible spending account that reimburses employee premium payments for other accident or health coverage extending beyond the end of the plan year.

### Section 125 Flexible Spending Accounts

An important type of tax-exempt arrangement under Section 125 is the "flexible spending account," which allows employees to pay for dependent care expenses (up to \$5,000 per year), adoption assistance, and health care, on a pre-tax basis. However, interested employees must elect to fund the flexible spending account prior to the beginning of the plan year by allocating "flex dollars" (employer contributions) into the account or agreeing to a pre-tax wage deduction each payroll period. When such employees incur and pay for qualified expenses, they may submit proof of payment to their employer or plan administrator. The employee is then reimbursed (free of income tax) from the participant's flexible spending account.

Medical expense spending accounts are the more common example of the flexible spending account feature. They are designed to help employees pay medical expenses such as insurance deductibles and co-insurance amounts, or other health-

related expenses such as dental, vision or hearing charges, that are not covered by an employer's medical insurance plan.

There is no requirement to report reimbursements from medical expense flexible spending accounts. Some employers provide employees with periodic statements during the year showing flexible spending account transactions. Also, they may report total reimbursements at year end in Box 14 of Form W-2, which is used for employee convenience to report any "other" amounts paid. However, the Internal Revenue Service requires employers to report annually the amount of dependent care benefits PAID under a plan, in Box 10 of Form W-2. Likewise, adoption benefits PAID out under a Section 125 adoption expense flexible spending account must be reported in Box 12 of Form W-2, using code "T."

Amounts remaining in the flexible spending account at the end of the year must be forfeited. Therefore, employees should be cautious not to fund their flexible spending accounts with amounts greater than the expenses they expect to incur.

### **Advantages For Employers**

An important reason for adopting a cafeteria plan is the tax saving that can be realized. Without a cafeteria plan, if the employee pays for the benefit, the payroll deduction does not lower the employee's taxable earnings. However, using a cafeteria plan, certain employee contributions may be paid on a pre-tax basis, so as to reduce taxable earnings, and thus reduce taxes. Importantly, both the employer and employee may realize tax savings under a cafeteria plan, because a reduction in the employee's taxable earnings also reduces the employer's match on employee FICA tax.

While a reduction in the employee's taxable wages theoretically would reduce the employer's FUTA tax liability, most employees earn more than \$7,000 annually, so it merely defers briefly the employer's FUTA tax liability.

As for the employer's state unemployment compensation insurance contribution, because the state taxable wage limits vary and are higher than the wage limit for FUTA tax, in some cases the employer's liability would be completely deferred. However, about half the states treat employee salary reduction amounts as taxable wages for purposes of the employer's state unemployment compensation insurance contribution.

More importantly perhaps, the cafeteria plan concept adds flexibility for the changing composition of today's workforce. It allows individual employees the opportunity to select for themselves the benefits that best meet their particular needs. For example, a young employee with children may opt for maximum medical coverage, while an older worker with children over age 18 may opt for less medical insurance coverage but increased life insurance coverage. Employers no longer must make these difficult benefit decisions on behalf of their employees.

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### **ITINs ARE NOT WELCOME IN THE PAYROLL WORLD**

Individual Taxpayer Identification Numbers (ITINs) are issued by the Internal Revenue Service, but for an EMPLOYEE they never are a valid substitute for the Social Security Number (SSN). ITINs are intended to be used only in NON-EMPLOYMENT situations, where the I.R.S. needs an "account number" to track non-employment tax liability and Federal income tax payments. In *Circular E, Employer's Tax Guide*, page 9, the I.R.S. specifically directs employers not to accept an ITIN in place of an SSN for employee identification.

Persons born in the United States, or who become U.S. citizens, or who are permanent U.S. residents ("Green Card" holders), are entitled to employment in the United States and will automatically receive an SSN if they apply for one. However, an alien must have "work papers" to receive an SSN. If a non-resident or resident alien seeking employment holds the required work papers (issued by the Bureau of Citizenship and Immigration

Services ---- BCIS), the alien may apply for and receive a Social Security Number.

The I.R.S. created the ITIN for aliens who do not have work papers, but need identification for some NON-WORK related tax purpose. For example, to report non-employment tax liability arising from interest earned on a bank account, dividends paid on common stock, or royalties derived from the oil produced by an oil well. An individual with an ITIN who later becomes eligible to work in the United States can and must then obtain an SSN.

Perhaps the greatest weakness of the ITIN from an employee point-of-view is that it is an "account number" not recognized by the Social Security Administration. Therefore, if an employee is added to payroll using an ITIN, the normal payroll tax deductions for Social Security and Medicare will be taken, but the SSA will be unable to credit that "employee" with the tax amounts deducted. The employer may satisfy its obligation by depositing the withheld taxes, but the employee will never receive the benefits which these taxes were intended to purchase.

One can identify an ITIN because it is a 9-digit number, beginning with the number "9," with either a "7" or "8" as the fourth digit, and it is formatted like an SSN (9NN-7N-NNNN). At year end, ITIN holders should receive Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, not the Form W-2 which employers give to their employees.

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### **ALL OF US HAVE SOME "DE MINIMIS" FRINGE BENEFITS ----- Can You Identify Them?**

Any employer-provided property or service having a value so small that accounting for it would be unreasonable or administratively impracticable, may be excluded from income as a "de minimis" fringe benefit. The frequency with which the benefit is provided is a factor to be considered when determining that the value is small. Examples of "de minimis" benefits include:

- An occasional ticket to the theater or a sporting event
- Occasional meal money or cab fare when employees are required to work overtime, provided the payments are not calculated on the basis of the number of hours worked
- Occasional typing of personal letters or personal use of office copying machines
- Occasional parties and picnics for employees, coffee and doughnuts
- The value of meals provided at a reduced price when provided at an employer-operated eating facility whose revenues at least equal its operating costs.

However, SEASON tickets to sporting or theatrical events, free use of a company car to commute to work, or the use of an employer-owned or leased boat, hunting lodge, etc. for a weekend, may not be considered "de minimis" benefits. Therefore, withholding for Federal income tax, Social Security and Medicare taxes, and the employer-paid FUTA tax, apply to the fair market value.

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### **RHODE ISLAND INCREASES MINIMUM WAGE**

As of March 1, 2006, the Rhode Island minimum wage rate was increased from \$6.75 to \$7.10 per hour. For tipped employees, the required minimum cash wage is unchanged at \$2.89 per hour. Therefore, the maximum tip credit increases from \$3.86 to \$4.21 per hour.

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