

Cafeteria Plans

A “cafeteria plan” is a written plan established by an employer for its employees that allows employees to choose between a taxable benefit (cash) and a menu of nontaxable “qualified” benefits. *IRC 125*. The idea is this—employees will not be taxed on the qualified noncash benefits they receive under the plan solely because they had the right to choose cash instead of any of the noncash benefits. As noted earlier in this chapter, it is a basic rule of tax law that employees who are given the choice of receiving a tax-free fringe benefit or cash must report the value of the fringe benefit as taxable income (assuming they choose the fringe benefit) because they had the right to receive a taxable benefit (cash). For example, the cost of employer-provided health insurance ordinarily is a tax-free fringe benefit to employees. However, employees cannot exclude the cost of this benefit from their taxable income if they had the right (whether it was exercised or not) to receive cash instead of having their employer pay their health insurance premiums. A cafeteria plan avoids this tax rule, and permits employees to receive certain tax-free fringe benefits from their employer even though they had the right to receive cash instead. However, note that a cafeteria plan must present employees with a choice between cash and one or more nontaxable fringe benefits. A plan that allows employees to choose among several noncash fringe benefits is not a cafeteria plan.

Employer contributions to a cafeteria plan are not taxable, even if they are funded through salary reductions. This makes such plans very attractive to employees. The term “cafeteria” refers to the choice employees have under such plans, and not to an eating facility (as is commonly supposed). The requirements for a cafeteria plan are complex. Churches interested in establishing such a plan should consult with a tax attorney or CPA. Here are a few rules to keep in mind:

- Choice of cash or fringe benefits. Employees must be given the option to choose between cash and a menu of nontaxable “qualified” benefits. Qualified benefits available under a cafeteria plan include:
- employer-paid group term life insurance coverage up to \$50,000
- employer-paid medical insurance premiums
- employer reimbursements of medical expenses under an accident or health plan
- employer-paid dependent care

The only taxable benefit that a cafeteria plan may offer is *cash*. That is, employees can be given the option of choosing among any of the benefits listed above, or cash. The following benefits may *not* be offered—scholarships, educational assistance programs, de minimis fringe benefits, no-additional-cost services, employee discounts, and “working condition fringe benefits.”

- Written plan. A cafeteria plan must be set forth in a written agreement. The income tax regulations describe the required agreement in some detail as follows:

The written document embodying a cafeteria plan must contain at least the following information: (i) a specific description of each of the benefits available under the plan, including the periods during which the benefits are provided (i.e. the periods of coverage), (ii) the plan’s eligibility rules governing participation, (iii) the procedures governing participants’ elections under the plan, including the period during which elections may be made, the extent to which elections are irrevocable, and the periods with respect to which elections are effective, (iv) the manner in which employer contributions may be made under the plan, such as by salary reduction agreement between the participant and the employer or by nonelective employer contributions to the plan, (v) the maximum amount of employer contributions available to any participant under the plan, and (vi) the plan year on which the cafeteria plan operates. *Proposed Treas. & Reg. 1.125-1 (question and answers~ answer A-3)*.

- Highly compensated employees. If a cafeteria plan discriminates in favor of “highly compensated employees” (defined above) then such employees lose the benefit of the exclusion and they generally are taxable on the value of the benefits received. Further, the exclusion is denied to “key employees” (defined above) if the qualified benefits provided to such employees exceed 25% of total nontaxable benefits provided to all employees under the plan. Special nondiscrimination rules apply to cafeteria plans that provide health benefits. *IRC 125 (g) (2)*.
- Elections Employees generally cannot make changes in their election of benefits, or their contribution amounts, under a cafeteria plan during the year. However, IRS regulations permit changes in benefit elections during the year under specified circumstances, including changes in cost or coverage, changes in family status, separation from service, when eligibility for Medicare or Medicaid is gained or lost, or when a court issues an order requiring that an employee’s dependent child or foster child receive health coverage. In addition, the regulations permit an employee to change his or her accident or health coverage election or group-term life insurance election if certain change in status rules are satisfied.

SAMPLE CAFETERIA PLAN

WHEREAS the _____ U.M.C. wants to allow employees to choose between a taxable benefit (cash) and a menu of nontaxable "qualified" benefits *IRC 125* that results in the most favorable tax treatment possible under Federal income tax law,

BE IT RESOLVED that the _____ United Methodist Church hereby establishes a Cafeteria Plan, hereinafter referred to as the "Plan," for the sole benefit of their employees and their dependents. This Plan shall be within the purview of Sections 105 and 106 of the U.S. Internal Revenue Code and shall become effective on _____. It shall continue in effect until terminated by a similar resolution of this church.

As part of this plan, this church shall establish and maintain a cafeteria account for each employee and shall, at least quarterly, reimburse employees for covered expenses incurred by them or their dependents. The maximum reimbursement to a participating employee for covered expenses incurred during only one calendar year shall be the amount contributed to the Plan for that same year by that employee through a written salary reduction agreement. All such salary reduction agreements shall be made in a manner approved by this church and shall be filed prior to the beginning of each new calendar year or within 10 days of an employee's initial entry into the Plan. Any participating employee applying for reimbursement under this Plan shall submit to the treasurer the documentation of covered expenses within six months of the time such expenses are incurred by the employee. Any balance remaining in a participating employee's account at the end of a calendar year, after all reimbursements for covered expenses incurred that year have been made in accordance with Plan provisions, shall be forfeited by the employee.

This Plan shall be administered in a non discriminatory fashion and shall be subject to amendment or termination at any time by the church, provided that such amendment or termination shall not affect a participating employee's right to reimbursement for expenses incurred prior to the amendment or termination. All decisions by this church regarding this Plan shall be binding and conclusive for all employees.

Benefits available include

- employer-paid group term life insurance coverage up to \$50,000
- employer-paid medical insurance premiums
- employer reimbursements of medical expenses under an accident or health plan
- employer-paid dependent care

The maximum amount of yearly employer contributions available to any participant is \$_____ .

Attested to this _____ day, _____, 20 __, the foregoing resolution is hereby accepted.

Chairperson Church /Administrative Board

Secretary

Treasurer