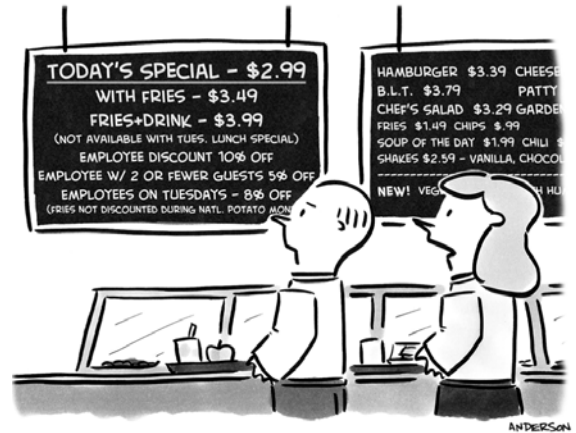




We Deliver Performance



CAFETERIA PLANS COMMON QUESTIONS AND ANSWERS

It's all About the Benefits!

WHAT IS A CAFETERIA PLAN?

A cafeteria plan is a benefit plan authorized by Section 125 of the Internal Revenue Code. It is a way of providing employees with valuable benefits, where both the employer and employees save significant amounts on taxes. Generally, employees are given a choice to “redirect” part of their salary. Each employee then uses the “redirected” part of his or her salary to purchase benefits from a “menu” of non-taxable benefits offered by the plan (hence the term “cafeteria”).

The employer may make further contributions to the plan (in addition to an employee’s own salary redirections) which employees may also use to purchase benefits. These benefits may include dependent care assistance programs (day care), uninsured medical expenses not covered by the typical group medical plan, group life and medical and disability premiums otherwise paid by the employee. Because cafeteria plans allow employees to choose the benefits they want, they are often referred to as flexible spending or flexible benefit plans.

HOW DOES A CAFETERIA PLAN WORK?

Each employee selects the benefits he or she wants from the cafeteria plan menu. The employee “pays for” these benefits by electing to redirect his or her salary in an amount sufficient to pay for each benefit. Most importantly to each employee, these amounts are redirected from the employee’s salary **before** it is subject to Federal income tax or Social Security taxes (FICA).

The redirected amounts are placed into a separate spending account for each benefit elected by the employee. Then, as each employee incurs a qualifying expense (e.g., a day care bill), he or she submits a claim to the plan administrator, who processes the claim and reimburses the employee from the money in the cafeteria plan.

There are significant benefits for both the employer and the employees. The primary benefit for employees is that they are not taxed on the salary they redirect into each benefit account, nor are they taxed when reimbursements are made. Therefore, through a cafeteria plan, employees can now pay for expenses with **pre-tax** dollars, the same expenses they were previously paying for with **after-tax** dollars.

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EXAMPLE: If an employee pays \$400 per month to have his or her children in a day care center, he or she can elect to have his or her salary reduced by \$400, and place this amount into the cafeteria plan dependent care account. Each month the employee submits a claim and is reimbursed for the \$400 which he or she has paid to the day care center. The employee has turned this expense from an after-tax expense into a pre-tax expense with the cafeteria plan, and thus has more disposable income each month.

WHAT HAPPENS TO MY CURRENT BENEFITS PROGRAM?

There is no change required in your group medical/dental or life insurance plans unless you would be changing them regardless of the cafeteria plan. The premium payments made by employees to cover their share or their dependents share of any medical premium would still be handled through your payroll. The only change is that all payments are pre-tax, rather than after-tax.

HOW WILL I, AS AN EMPLOYER, BENEFIT FROM INSTALLING A CAFETERIA PLAN?

Generally, you will benefit in four primary ways:

1. Saving Employment Taxes

You will not have to pay FICA or FUTA employment taxes on the gross amount of salary redirections made by your employees. In many states, state unemployment and worker's compensation taxes can also be avoided on the amount of salary redirections. Because the salary redirection amounts remain in your company bank account until an expense reimbursement is made for an employee, you will earn interest on these amounts. An example can best explain the savings to you:

Total amount salary redirections by employees	\$60,000
Savings in FICA at 7.65%	4,590
Interest on \$60,000 at 3%	<u>1,800</u>
Estimated Savings	\$ 6,390

Of course, the more your employees participate, and the higher their salary redirections, the more you save each year.

2. You may be eligible to participate

You, personally, may benefit by being a participant in the plan in the same manner as your employees. You can pay for your uninsured medical expenses, dependent health premiums and dependent childcare with pre-tax dollars and end up with more disposable income, too.

3. Employee Morale

You also benefit by providing a true employee benefit to your employees, one that will give them more disposable income each month. An employee's disposable income will rise because he will be paying for these ongoing expenses with pre-tax rather than after-tax dollars. Many employers find this helps promote loyalty, motivation and general employee satisfaction, with the resulting long-term benefits to your business.

4. Cost Containment

Some cafeteria plans can be designed and structured to provide employers with cost containment on the ever-increasing expense of providing fringe benefits, particularly with some forms of health plans.

The following example illustrates the savings to a typical employee:

	Without Cafeteria Plan	With Cafeteria Plan
Gross Monthly Compensation	\$1,000.00	\$1,000.00
Less Pre-Tax Expenses		
• Medical Expense		25.00
• Dependent Child Care		200.00
• Group Medical Insurance Premium		50.00
• Group Life Insurance Premium		<u>2.00</u>
Gross Taxable Income	\$1,000.00	\$ 723.00
Less Taxes and After-Tax Expenses		
• Federal Income Tax at 20%	\$ 200.00	\$ 144.60
• State Income Tax at 10%	100.00	72.30
• Social Security Tax at 7.65%	76.50	55.31
• Group Medical Insurance Premium	50.00	0.00
• Group Life Insurance Premium	<u>2.00</u>	<u>0.00</u>
Net Paycheck	\$ 571.50	\$ 450.79
Plus Cafeteria Plan Reimbursements		
• Medical Expense Reimbursement		\$ 25.00
• Dependent Child Care Reimbursement		<u>200.00</u>
Disposable Income	\$ 571.50	\$ 675.79
Estimated Increase in Disposable Income Per Month		\$ 104.29
Estimated Increase in Disposable Income Per Year		\$1,251.48

These savings represent an increase of 18% in this employee's disposable income, a substantial effective pay increase.

WHAT BENEFITS CAN BE OFFERED AS PART OF A CAFETERIA PLAN?

The allowable non-taxable benefits include both insured and non-insured benefits:

Insured Benefits

- Accident and Health Insurance
- Group Term Life Insurance
- Disability Insurance
- Dental Insurance

Non-Insured Benefits

- Dependent Care Assistance Programs (Day Care)
- Medical/Dental Reimbursement Plan (for non-insured medical/dental expenses)

A cafeteria plan permits an employee to elect cash as an option from the plan “menu” in addition to these non-taxable benefits, an employee can therefore elect not to redirect his or her pay or purchase allowable benefits. Instead, the employee selects the cash option and receives his or her full salary. Obviously, this employee would pay taxes on the cash amount received.

A plan can offer some or all of these allowable benefits. You, the employer, choose which benefits to make available to employees. Employees, in turn, select the benefits that most suit their needs.

WHAT KIND OF NON-INSURED MEDICAL EXPENSES CAN BE PAID FOR BY THE CAFETERIA PLAN?

The following list includes example of expenses that may be paid under the cafeteria plan. It includes, generally, any expense that is deductible under Section 213 of the Internal Revenue Code.

- Acupuncture
- Artificial limbs and teeth
- Automobile modifications (hand controls, special equipment, mechanical lifts)
- Birth control pills
- Dental treatment
- Drugs (legal – prescription only or insulin) and medical supplies
- Eyeglasses/Laser vision correction
- Fees:
 - Anesthetist
 - Blood donor
 - Chiropractor
 - Dentist
 - Examination, physical
 - Eye examination
 - Gynecologist
 - Hospital
 - Laboratory
 - Nurse
 - Ophthalmologist
 - Optician
 - Optometrist
 - Oral surgery
 - Osteopath
 - Pediatrician
 - Physician
 - Physiotherapist
 - Podiatrist
 - Psychiatrist
 - Psychologist
 - Psychoanalyst
 - Non-cosmetic surgery
 - Therapy

- Hearing devices
- Hospital bills
- Obstetrical expense
- Operations & related treatments
- Over-the-counter medications
- Oxygen equipment
- Sanitarium or rest home
- Support or corrective devices (including special mattress and board for arthritis)
- Transportation expense relative to illness
- Vasectomy
- X-rays

WHY WOULD AN EMPLOYEE ELECT NON-INSURED MEDICAL EXPENSES AS PART OF THE CAFETERIA PLAN IF I ALREADY PROVIDE MEDICAL INSURANCE TO ALL EMPLOYEES?

The medical reimbursement plan you could offer in a cafeteria plan could cover expenses not covered by your group medical insurance plan. That might include expenses like those discussed above, co-pay amounts that employees pay as part of your group insurance or deductible amounts that employees are required to pay themselves.

WHY IS A CHOICE AMONG BENEFITS IMPORTANT?

Not all employees have the same needs. For example, some employees have spouses who are employed on a full-time basis and covered by a health insurance plan. Such employees may not need dependent health insurance under your company's plan, but would prefer to purchase more life insurance instead.

Other employees with working spouses and young children may opt for dependent care (day care) coverage. If the employee's spouse stays in the home and takes care of the children, dependent health insurance coverage will probably be the most important benefit.

Cafeteria plans give employees the opportunity to choose the benefits most important to their particular situations, and to pay for these benefits on a tax-advantaged basis. Employees appreciate this unique approach, and the savings they realize as well.

WHO PAYS FOR THE CAFETERIA PLAN BENEFITS?

Most cafeteria plans are set up to be funded only with salary redirections from participants. No contributions are required by the employer, although you can decide to make a contribution on behalf of all participants, if you choose.

The only requirement is for separate recordkeeping for each participant's account. We can provide the recordkeeping service for your plan, or recommend ways to handle it.

Each benefit that the participant has selected must be accounted for separately. As requests for reimbursement are made by each participant, the records detailing how much money remains in the account will need to be updated. Actual reimbursement can be made through your payroll department, or the checks can be prepared by Polycomp.

WHEN ARE SALARY REDIRECTIONS AND BENEFITS ELECTED?

Your cafeteria plan will operate on a 12-month plan year. Prior to the beginning of each plan year, each employee will select which benefits (if any) he or she wants to fund by redirecting a portion of his or her salary into the appropriate spending accounts. Conservative estimates should be used to ensure that the employee's reimbursements would use up his entire account during the year.

ONCE THE ELECTION IS MADE, CAN THE PARTICIPANT CHANGE HIS MIND DURING THE YEAR?

The elections, once made, are irrevocable for that plan year. New elections are made prior to the beginning of each subsequent plan year.

However, certain situations, known as changes in family status, can arise during the plan year which allow the participant to change an election.

These situations include:

- Marriage of the participant
- Divorce of the participant
- Death of a spouse or child of the participant
- Birth or adoption of a child (pregnancy does not constitute a change in family status)
- Termination of a spouse's employment
- Employment of the spouse
- Switching from part-time to full-time employment, or vice versa, by the participant or spouse

WHAT HAPPENS IF THERE IS MONEY LEFT IN THE PARTICIPANT'S ACCOUNT AT THE END OF A YEAR AND HE OR SHE HAS NO MORE REIMBURSEMENT REQUESTS?

In that case, the participant forfeits the money in the account and the money remains as a general asset of the employer. This is the "use it or lose it" feature of a cafeteria plan that you may have heard of.

For this reason, participants need to make conservative estimates of their reimbursable expenses prior to each plan year. Dependent childcare and group medical and life insurance premiums are generally easy to estimate. Medical expenses not covered by insurance are harder to predict. However, experience shows that when a participant is informed that he has money left in his or her account and the year is coming to an end, they then go for the checkup they've been putting off, or get the new pair of glasses they've needed, etc. With proper planning, forfeitures are therefore quite uncommon.

Communication of the cafeteria plan and its benefits is critical to the success of the plan. We can recommend different methods of enhancing the communication process to help make your plan more successful.

WHEN DO I REIMBURSE A PARTICIPANT'S NON-INSURED MEDICAL EXPENSE?

The Rules require that participants be reimbursed for the full amount of their request, even if the participant hasn't yet redirected enough salary into his account to cover the entire amount. The only requirement is that the request for reimbursement not exceed the total amount the participant has elected to set aside in that account for the entire year.

Some employers object to this Rule. We can recommend several ways to eliminate possible employer risk if an employee were to terminate. For example, one method might be to place limits on the amounts that participants can redirect into a medical reimbursement account. There are also other methods we can discuss.

CAN ALL EMPLOYEES PARTICIPATE IN A CAFETERIA PLAN?

Partners in a partnership, sole proprietors, members of a limited liability corporation and owners who own 2% or more of a subchapter S corporation cannot participate in a cafeteria plan.

WHAT ARE THE REQUIREMENTS FOR INSTALLING A CAFETERIA PLAN?

The only requirement for installing a cafeteria plan is to adopt the plan, execute a plan document and have all eligible employees make their benefit elections. Summary Plan Descriptions detailing the plan's eligibility requirements, benefits and election requirements must be given to all employees. There is currently no initial filing for a determination letter with the IRS, as there is for qualified retirement plans. However, there is an annual IRS reporting requirement, using Form 5500.

One of the factors most critical to the success of a cafeteria plan is the communication and enrollment process for employees. If care is taken in informing employees of the advantages of cafeteria plans and in signing them up, there is a much greater likelihood of success.

We can provide you with all of these plan installation items and services, or advise you how to handle them.

AFTER THE PLAN IS INSTALLED, WHAT RESPONSIBILITIES WILL THE EMPLOYER HAVE?

If the plan covers non-insured benefits or dependent care, then administrative recordkeeping will be required for the accounts of each participant. Tracking money that comes into each account through payroll deductions and reimbursements as they are paid. Plans that provide for insured benefits only require less administrative recordkeeping. The payroll department can merely adjust employee-paid premiums to pre-tax dollars rather than after-tax payments.

Also, participants should sign new election forms each year, deciding which cafeteria plan benefits they want for the upcoming plan year.

ARE THERE LIMITS ON HOW MUCH EACH PARTICIPANT CAN ELECT TO PUT INTO ANY SINGLE BENEFIT?

There is a \$5,000 limit on expenses that may be paid each calendar year for dependent care benefits for married couples who file joint returns. Other than that, there are no limitations on amounts allocated to particular benefits. However, there is a general non-discrimination requirement that says no more than 25% of the cafeteria plan's reimbursements can be made to "key employees". A key employee is generally defined as someone who owns more than 5% of the company, is an officer earning more than \$70,000, or owns 1% or more and earns more than \$150,000. If the 25% reimbursement limitation is exceeded, the reimbursements may be included in the income of the applicable key employees for income tax purposes.

Before you institute a cafeteria plan, you should determine whether this discrimination test is likely to cause any problems. Generally, companies with 25 or more employees do not violate these tests, and many smaller companies qualify as well.

SHOULD I INSTALL A CAFETERIA PLAN?

Many employers have been faced with the same question, and have decided to implement a cafeteria plan. Their reasons included:

- They felt their employees would appreciate the "choice" aspect of cafeteria plans; picking and choosing benefits most suited to **their** needs.
- Employees also appreciate the increase in disposable income produced by paying expenses through the tax advantage cafeteria plan.
- Employers will save considerable sums through reduced social security tax obligations; these savings are usually sufficient to cover most or all of the plan implementation and annual administration costs.
- Providing employees with this type of fringe benefit plan provides a competitive edge for an employer in attracting and retaining good employees.
- Basically, employers feel these and other advantages far outweigh the administrative responsibilities these plans entail. These employers agree that cafeteria plans provide a new and unique method for providing employees with benefits they want and need in a cost-effective manner.

Contact our firm if you would like further information on whether or not to install a cafeteria plan, or how to proceed if you've decided to do so.