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INSURANCE: EMPLOYEE BENEFITS

Cafeteria Plans Serve Up Options

Shopping A La Carte Gives Employees More Flexibility

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GRAND RAPIDS — A cafeteria plan can generate greater tax savings for both employee and employer, yet it tends to be one of the most underused employee benefits, particularly among small businesses.

Cafeteria plans are also known as 125 plans because they come under Section 125 of the Internal Revenue Service Code. There are a couple of components to a Section 125 plan, said April Lynn Yates, executive vice president of Mills Benefit Group LLC. One is to provide a vehicle for pre-tax premium deduction from an employee's paycheck. The other dictates rules for participation in flexible spending accounts both for health care and dependent care, which allows a tax-free deferral out of an employee's pay to cover qualified services on a tax-free basis.

Cafeteria plans can include dental, medical and vision benefits, depending on what a particular employer chooses to offer, Yates said. The more common cafeteria plans are the premium-only plans. A "full" cafeteria plan, on the other hand, permits employees to withhold a portion of their salary on a pre-tax basis to cover group health premiums, as well as maintain a flexible spending account to cover unreimbursed medical costs and dependent care expenses. Cafeteria plans give them the option of selecting only the benefits that best fit their needs.

Since cafeteria plan benefits are free from federal and state income taxes, the employee's taxable income is reduced so the percentage of his take-home pay increases. For employers, the major advantage of a cafeteria plan is reduced payroll tax liability.

Every dollar pumped into the plan reduces the employer's payroll by that amount, so the employer doesn't have to pay FICA or workers' compensation premiums on those dollars.

Pat Dalton, an employee benefits specialist with Berends Hendricks Stuit Insurance Agency Inc., said most companies with 25-plus employees at least know about the cafeteria plan or are considering it because of the payroll tax benefits. In his agency's experience, 90 percent or more of businesses that offer a cafeteria plan offer the premium-only plan because they are relatively easy and very inexpensive to put in place, he said.

One thing that discourages some employees from participating in a full cafeteria plan is the use-it-or-lose-it restriction, which applies only to flexible spending accounts. The restriction requires that any unused portion of the account be returned to the employer at the end of the plan year. At least initially, that turns off some employees because they fear they'll lose some of their money, Dalton said.

But as he sees it, having immediate access to that money is one of the greatest advantages for employees. Once an employee goes through the election period and decides what he's going to put aside for the year, he can access the entire amount at the start of the plan year.

"If I decide to put aside \$3,000 for the year, I can access all \$3,000 early on and go get LASIK eye surgery, even though I've only started funding a small portion of that through my payroll,"

he explained. "Now a lot of our plans are offering debit cards associated with that money, so you can access that money faster and easier and you don't have to get reimbursement."

There's built-in risk for both the employee and the employer, which is why the use-it-or-lose-it rule exists, Yates explained. The employee risks forfeiting money that's not used within the plan period and the employer faces the risk of advancing funds early on and then having an employee terminate his employment. If, for instance, an employee elects to have LASIK surgery in January, when only one-twelfth of the amount he set aside has been deducted from his paycheck, and then quits in February, the employer is stuck with the remaining cost of the surgery.

About three years ago the list of what was covered under a flex-spending account was expanded to include over-the-counter medications and anything health related, such as a knee brace or pair of prescription

sunglasses, so it's really not hard to spend the dollars anymore, Yates said.

Among the employers served by Mills Benefit Group, all offer the premium-only component that allows pretax premium deductions, Yates said, and, typically, most of their plans include a flex spending account opportunity. Other than the administrative costs of operating a Section 125 benefits plan, which run about \$4.50 to \$6.50 per person per month, Yates said she can't think of any good reason not to offer a flexible spending account.

"Most employers find it necessary to set up a cafeteria plan in order to attract and retain a qualified work force," Yates said. "Employers have better results from employees that are happy and feel secure in terms of a benefits program; those are securities that typically make a work force more productive."

As employees get older, Yates noted, they may not want to participate in a Section 125 plan since it reduces taxable income, and taxable income is what Social Security uses to determine each person's benefit.

Some small businesses may initially worry that existing staff won't be able to handle the administrative issues, Dalton said. But most employers outsource their benefits administration anyway rather than do it internally because it's relatively inexpensive per person, particularly the more employees a company has, he pointed out.

"Usually administrative costs versus employees taking a part in the plan will basically break even at some point," he said. "Most companies with 25-plus employees at least know about the cafeteria plan or are considering it because of the payroll tax benefits." **BJ**

