Sec 125 Cafeteria Plans & Flexible Spending Accounts Report

Prepared for:

Wisconsin Benefits Valued Clients

Prepared by:

Charles Ouimette
Wisconsin Benefit Planning, Inc.
315 E. Front St.
PO Box 1089
Minocqua, WI. 54548

Phone: 715-356-2300
Mobile: 715-892-1748
Fax: 715-356-7974
Email: charlieo@teamwbp.com
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Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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Cafeteria Plans

IRC Sec. 125

Also called flexible benefit plans, cafeteria plans allow participating employees to choose among two or more benefits consisting of cash and qualified benefits. See IRC Sec. 125(d)(1)(B).

There is no need to change current benefit programs. If the employer is unable to pay for fringe benefits, the employee can enter into a salary-reduction agreement with the employer. The employer then uses these funds to pay for the employee's benefits. This allows the employee to pay for his or her own benefits with pre-tax dollars.

Employee Benefits

Some of the benefits that can be enjoyed by employees include the following:

- Lower FICA and income tax withholding due to lower gross pay
- Ability to select those benefits most needed
- Opportunity to refuse benefits already provided by a spouse's employer
- Option of redirecting tax savings to meet retirement needs, i.e., 401(k) plan
- Potential qualification for the earned-income credit due to lower gross income

Employer Benefits

Some of the benefits that can be enjoyed by employers include the following:

- Lower payroll taxes (FICA, FUTA and sometimes worker's compensation insurance) due to lower gross pay
- Sharing cost of benefits with employee, if desired
- Help in retaining key employees
- Improved employee morale due to show of employer concern
- Potential reduction in fringe benefit costs

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IRC Sec. 125

Qualified Benefits May Include

- Accident and health insurance
- Health Savings Account (HSAs)
- Group term life insurance
- Dependent care assistance
- Flexible-spending accounts
- Cash-or-deferred arrangements (401(k) plans)
- Adoption assistance

Excluded Benefits

- Scholarships or fellowships described in IRC Sec. 117
- Educational assistance programs described in IRC Sec. 127
- Miscellaneous fringe benefits (including transportation and parking) described in IRC Sec. 132[1]
- Nonqualified deferred compensation plans
- Qualified retirement plans, except cash or deferred arrangements under IRC Sec. 401(k)
- Long-term care benefits, including long-term care insurance or services
- Contributions to medical savings accounts described in IRC Sec. 220
- Health reimbursement arrangements described in Revenue Ruling 2002-41

Plan Requirements

The plan must be written and include only employees.[2] The plan should include the following items.

- Description of benefits and coverage periods
- Eligibility rules for participation
- How benefit elections are to be made
- How employer contributions are to be made, i.e., employer funds or salary reduction
- Maximum amount of employer contributions
- Plan year[3]

[1] The Transportation Equity Act of 1998 allows pretax contributions for qualifying transit vouchers or parking, but these cannot be part of a cafeteria plan.
[2] Sole proprietors and partners (or attributed partners) or subchapter S shareholders who own (or who are attributed to own) 2% or more of the business may not participate.
[3] See proposed Regulation Sec. 1.125-(d)

Cafeteria Plans

IRC Sec. 125

Discrimination

The plan must be available to employees who qualify under a classification established by the employer and cannot discriminate in favor of highly-compensated or key employees.

One discrimination test that greatly impacts smaller employers is the 25% rule. The statutory, non-taxable benefits provided to key employees may not exceed 25% of the statutory, non-taxable benefits provided to all employees. If nondiscrimination rules are violated, key employees lose the benefit of the cafeteria plan and are taxed on the maximum amount of cash or taxable benefits. There is no effect on rank and file workers.

Key participants are any participants and participants' beneficiaries who, during the determination year,[1]

- are or were an officer of the sponsoring employer and earning more than $165,000[2];
- owned more than 5%[3] of the employer; or
- owned more than 1%[3] of the employer and received more than $150,000 of compensation from the employer.

Simple Cafeteria Plans

Beginning in 2011, one provision of the Patient Protection and Affordable Care Act (PPACA) provides qualified small employers with a simplified "safe harbor" method of meeting the nondiscrimination requirements applicable to cafeteria plans. Under this safe harbor, a cafeteria plan is treated as meeting the nondiscrimination rules if the plan satisfies certain minimum eligibility, participation, and contribution requirements. An eligible small employer is, generally, an employer who employed an average of 100 or fewer employees on business days during either of the two preceding years.

2007 Proposed Regulations

On August 6, 2007, the IRS issued proposed regulations (NPRM REG-142695-05) on a number of issues related to cafeteria plans, including nondiscrimination rules. This suggests that the IRS will be paying more attention to this area in the future. These proposed regulations are generally applicable to plan years beginning on or after January 1, 2009.

[1] In-service distributions are subject to a five-year look-back period.
[2] This value applies to 2013.
[3] The family attribution rules of IRC Sec. 318 apply. Any participant is deemed to have the same ownership share as his or her spouse, children, parents and grandparents.

Flexible Spending Accounts

Flexible spending accounts (FSA) are a type of cafeteria plan commonly used by many employers. In an FSA, participating employees generally elect to have their salary reduced each month. The employer then uses these funds to pay for certain benefits with pretax dollars. There are three types of FSAs:

1. Medical expenses not otherwise covered
2. Dependent care expenses for both children and parents
3. Adoption expenses

Tax Benefits

The payment of the benefit is tax deductible for the employer and is not considered additional income to the employee. As these dollars are not considered to be wages, they are not subject to either FICA or FUTA tax.

Health Benefits

If an FSA provides health benefits (like medical or dental expenses) to participants, it must be ready to pay the full year's benefits to an employee who qualifies for the benefit.

For example, if the employee has contributed for only one or two months at the time of the claim, the employer must pay for the entire expense up to the amount projected for the full year of contributions by the employee.

If the employee then terminates employment before the amounts are deducted from his or her paycheck, the employer must suffer the loss.

Beginning in 2013, the maximum amount available for reimbursement of incurred medical expenses for a plan year may not exceed $2,500. The $2,500 limit will be adjusted for inflation for years after 2013.

"Use-Or-Lose" Rule

Any unused funds remaining in an FSA at the end of the year will be forfeited by the employee. At the beginning of the year, a careful estimate of future expenses is helpful in avoiding this "use-it-or-lose-it" problem. However, employers may (but are not required to) establish a grace period of 2 ½ months after the end of a plan year. During this grace period, any unused funds may be paid or reimbursed to the employee for qualified expenses incurred during the grace period.[1]

[1] See proposed regulation Sec. 1.125-1 (e)

Flexible Spending Accounts

Qualified Reservist Distribution

Under the provisions of the Heroes Earnings Assistance and Tax Relief Act of 2008, for distributions after June 17, 2008, a "qualified reservist distribution," of all or part of any unused balance remaining in a health FSA may be made to an employee who is called to active duty for a period of more than 179 days, or indefinitely. The distribution must be made during the period beginning with the date the individual is called to active duty and ending on the last date that reimbursements could be made under the arrangement for the plan year that includes the date of call to active duty.

Qualified reservist distributions are not required. If a plan sponsor decides to allow them, they must be available to all eligible plan participants and the plan must be amended.