

Cafeteria Plans and Flexible Spending Accounts are Excludable for Social Security, Medicare & Federal Income Taxes

The terms “cafeteria plan,” “flexible benefit plan” and “flex plan” are used to describe an approach to compensating employees where employees may choose from a selection of different benefit options. Types of benefits offered under such arrangements may include accident and health benefits, group-term life insurance, dependent care assistance, group legal services, elective vacation days and health care “flexible spending accounts.”

A typical flexible benefit plan provides a set of core benefits that the employee must accept as well as a set of optional levels of coverage or benefits. By choosing among these benefit options, employees are able to eliminate duplicative or unwanted coverage and select alternatives that meet their specific needs.

Taxability of Cafeteria Plans

The terms “cafeteria plan” and “flexible benefit plan” often are used interchangeably. “Cafeteria plan” is, however, a term specifically used in Internal Revenue Code Section 125 to describe tax-preferred plans that provide employees a choice of two or more benefits consisting of cash and certain nontaxable benefits.

“Flexible benefits,” on the other hand, is a generic term applied to any type of arrangement that offers employees a choice among benefits.

Under cafeteria plans, benefits are generally

paid for with pre— tax credits or through salary reduction so that employees save both federal and state income taxes, as well as social security and/or medicare taxes. In turn, employers pay less social security and/or medicare taxes because the employees’ taxable wages are reduced.

Kentucky governmental employers began implementing cafeteria plans in the early 1980s. Social security withholding requirements and definitions, until January 1, 1987, were based on Social Security Administration laws and interpretations. The SSA held, for any wages paid prior to January 1, 1987, that amounts contributed under cafeteria plans were taxable for social security and medicare, but were exempt from federal income tax withholding.

On January 1, 1987, the withholding requirements for government employers were brought under IRS laws and regulations. IRS rules require uniform treatment for contributions to cafeteria plans in regards to social security and medicare withholding, as well as, income tax withholding. Therefore, benefits under cafeteria plans or flexible spending accounts paid after January 1, 1987, are not taxable for social security, medicare or federal income tax.

Cafeteria plans

IRC Section 125 defines a cafeteria plan as an arrangement under which an employee has a choice between cash or “qualified benefits”—i.e., tax deferred benefits. Sections 125 provides that qualified benefits elected under a cafeteria plan are not taxable to the employee even though the employee otherwise could elect to receive cash in lieu of a qualified benefit. Basic requirements of Section 125 are that

employees make irrevocable benefit elections prior to the beginning of each plan year and that the plans not operate in a manner that allows employees to defer income.

Section 125 also specifies writing and reporting requirements as well as what types of benefits may be offered and which are prohibited. Employers also must bear in mind that each tax-preferred benefit offered by the plan must meet the requirements of the federal tax code section applicable to that particular benefit.

Section 125 requires cafeteria arrangements to offer both a taxable benefit and at least one qualified nontaxable benefit. Therefore, a plan that offers a choice between only two or more nontaxable benefits is not a Section 125 cafeteria plan.

Flexible Spending Accounts

Flexible spending accounts (FSAs) are qualified arrangements under IRC Section 125 that effectively allow employees to pay for certain qualified expenses—i.e., health care and dependent care expenses—on a pre-tax basis. FSAs may be offered either as an option in a cafeteria plan or as a stand-alone plan.

Employees must elect to fund an FSA prior to the beginning of the plan year by allocating “flex dollars” into the account or agreeing to a salary reduction. When employees incur and pay for qualified expenses, they may submit proof of payment (a receipt or written statement from a third party provider) to their employer, which in turn reimburses the employees from their respective accounts.

In electing to fund an FSA, employees should take care not to fund their account with an amount greater than the expenses they will incur, since any amounts remaining at the end of the plan year must be forfeited.

Most reimbursement accounts that have been established to date are medical expense FSAs, designed to help employees pay medical expenses, such as deductibles and co-insurance amounts, or other health-related expenses, such as dental, vision or hearing-care charges, that are not covered by an employee’s health insurance plan. Under a dependent care flexible spending account, employees may be reimbursed for up to \$5,000 (\$2,500 for married taxpayers filing separately) of dependent care expenses each plan year. Eligible expenses are non-medical expenses that enable the employee to be gainfully employed and ensure a “qualifying” dependent’s well-being and protection. Qualifying dependents are children under age 13 and disabled spouses and other dependents who are physically or mentally incapable of self care.