

Section 125 Plans — Do You Need One?

Many employers today struggle with the challenge of providing an attractive compensation package at an affordable price. One tool available to meet this challenge is the Section 125 Plan. While there are different types of Section 125 plans, each provides the opportunity to save money by reducing both the employer's and employee's tax liability. This article will outline for you the basics of offering a Section 125 plan.

What is a Section 125 plan?

A Section 125 plan may be established pursuant to rules found in the Internal Revenue Code Section 125. This IRC provision provides an exception to what is generally called the "constructive receipt doctrine." If an employer wants to allow an employee to pay his or her portion of insurance premiums with pre-tax dollars, the reduction of salary in exchange for employee benefits runs afoul of the constructive receipt doctrine. Under the constructive receipt doctrine, offering an employee a choice between cash and an employee benefit requires that the amount that could have been received be included in gross income. Thus, without a Section 125 plan, employee contributions can only be made with after tax dollars.

What are the different forms of Section 125 plans?

The three basic forms of Section 125 plans are:

- Premium Only Plan;
- Flexible Spending Accounts; and
- Full Cafeteria Plan.

What is a Premium Only Plan?

The Premium Only Plan is the most basic type of Section 125 plan and the most popular. A Premium Only Plan allows employees to pay their portion of insurance premiums with pre-tax dollars, which in turn reduces both the employer's and employee's tax liability. Benefits that are typically offered within a Premium Only Plan include: health, dental, vision, accidental death and dismemberment, and group term life insurance up to \$50,000.

Example: Employer Tax Savings

Thirty employees elect health insurance coverage. Under a Premium Only Plan, the employee's monthly premium contribution of \$125 per month is paid with pre-tax dollars.

Employer Tax Savings With Premium Only Plan	
Insurance Premiums (\$125 X 30 employees)	\$3,750
	x 12
Annual Salary Reduction	\$45,000
Employer Tax Rate*	9%
Employer Tax Savings	<u>\$4,050</u>

*Includes FICA, FUTA, and estimated SUTA.

What is a Flexible Spending Account?

Under IRC Section 125, employees may make pre-tax contributions to a Flexible Spending Account. An employee may seek reimbursement from the Flexible Spending Account for expenses paid for child care, deductibles, and eligible medical expenses not otherwise covered under a health insurance plan. A Flexible Spending Account allows an employee to increase his or her spendable income while also reducing the employer's tax liability.

Example: Employee's Spendable Income Increases

Without Section 125 Plan		With Section 125 Plan	
Annual Salary	\$ 24,000	Annual Salary	\$ 24,000
Federal Income Tax (15%)	- 3,600	Health Insurance Premiums	- 1,500
State Income Tax (3%)	- 720	Out of Pocket Medical Expenses	- 300
Social Security Tax (7.65%)	- 1,836	Child Care Expenses	- 2,800
Net Income	\$ 17,844	Net Income	\$ 19,400
Health Insurance Premiums	- 1,500	Federal Income Tax (15%)	- 2,910
Out of Pocket Medical Expenses	- 300	State Income Tax (3%)	- 582
Child Care Expenses	- 2,800	Social Security Tax (7.65%)	- 1,484
Remaining Spendable Income	<u>\$ 13,244</u>	Remaining Spendable Income	<u>\$ 14,424</u>

The example above demonstrates an annual increase in spendable income if both a Premium Only Plan and Flexible Spending Account are utilized. While use of either a Premium Only Plan or Flexible Spending Account alone would produce a savings, the increase in spendable income would be less.

What is a Full Cafeteria Plan?

Under a Full Cafeteria Plan, the employer makes a non-elective contribution for every eligible employee. The employees may spend the employer contribution to purchase any of the benefits offered within the Cafeteria Plan. In addition, the employee may contribute pre-tax dollars to purchase additional benefits beyond what he or she can purchase with the employer's contribution.

Can an employer offer its employees a choice between cash and benefits?

Yes. If an employer has in place a Premium Only Plan or a Full Cafeteria Plan, it can offer its employees a cash-out option. For example, an employer may offer its employees \$500 if the employee does not elect benefits and demonstrates that they have other coverage available through another group health plan. Because an employee that waives coverage in exchange for the \$500 payment can later elect coverage following a qualifying event, it is suggested that the cash is paid in equal installments throughout the plan year.

What are the disadvantages of offering a Section 125 plan?

For an *employee*, the disadvantages of participating in a Section 125 plan include:

- An employee may not change his or her elections throughout the plan year unless he or she experiences a qualifying status change (i.e., birth of child, marriage).
- Any unused funds remaining within a Flexible Spending Account at the end of the plan year and any applicable grace period are lost.
- While a Section 125 plan reduces the employee's taxable income, it also may reduce other benefits. Benefits which are calculated using the employee's income (i.e., social security or retirement benefits) will in turn be reduced.

For an *employer*, the disadvantages of participating in a Section 125 plan include:

- While the employer reduces its tax liability, it is responsible for the cost, establishment, and maintenance of the plan.
- Employers offering a Flexible Spending Account bear some risk of loss. The uniform coverage requirement rule requires that the full amount elected by the employee be made available to the employee at the beginning of the plan year, and this may be detrimental to the interests of the employer.

Example: An employee could elect to withhold \$3,600 during the plan. The employee contributes \$300 each month. On January 15th, the employee submits a \$3,600 receipt for his corrective eye surgery performed a week earlier. The employee is entitled to reimbursement of \$3,600. Ten days later the employee terminates his employment. The employer is not entitled to recover from the employee the balance owed the Flexible Spending Account. For this reason, some employers limit the amount an employee can contribute to the Flexible Spending Account.

[B_OfficialName] welcomes the opportunity to help your organization examine its plan design(s) and make recommendations for improvement.

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