About the Section 125 (or Cafeteria) Plan

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Numerous employers across the U.S. set up and use various types of employee benefits plans allowed by the Internal Revenue Service (IRS). One of these plans, the Section 125 (or cafeteria) plan, has been in existence since 1978. It offers some interesting advantages.

KEY TAKEAWAYS

- A Section 125 or cafeteria plan is an employer-sponsored benefit plan that gives employees access to certain taxable and nontaxable pretax benefits.
- The plan can be made available to employees, their spouses, and their dependents. Former employees are also allowed access, but the plan can't exist primarily for such people.
- Employees must be allowed to choose from at least one taxable benefit, such as cash, and one qualified benefit, such as a Health Savings Account.
- Employees agree to contribute a portion of their salary on a pretax basis to pay for the qualified benefits and that portion is not considered wages for federal income tax purposes.
- Cafeteria plan contributions are not usually subject to FICA taxes, which help fund Social Security or Medicare, or FUTA taxes, which fund the federal unemployment insurance program. [1]

What Is a Section 125 (or Cafeteria) Plan?

A Section 125 plan is part of the IRS code that enables and allows employees to take taxable benefits, such as a cash salary, and convert them into nontaxable regular expenses that are related to medical issues and child care.

Employees who are enrolled in a Section 125 plan can set aside insurance premiums and other funds pretax, which can then go toward certain qualified medical and childcare expenses. Depending on where they live, participating employees can save from 20% to 40% in combined federal, state, and local taxes on a variety of items that they typically already purchase with out-of-pocket post-tax funds. Employers can save an additional 7.65% on their share of payroll taxes. [2]

Who Can Open a Section 125 Plan?

Section 125 plans must be created by an employer. The benefits are available to employees, their spouses, and their dependents when a plan is created. Depending on the circumstances and details of the plan, Section 125 benefits may also extend to former employees but the plan cannot exist primarily for them.

Benefits to Employers and Employees

Section 125 plans offer employers a lot of tax-saving benefits. Employers save on the Federal Insurance Contributions Act (FICA) tax, the Federal Unemployment Tax Act (FUTA) tax, the State Unemployment Tax Act (SUTA) tax, and workers' compensation insurance premiums for each participant in the plan. Combined with the other tax savings, the Section 125 plan usually funds itself because the cost to open the plan is low. [1]

As an added advantage, employees receive an effective raise without any additional cost to the employer. More participants in the plan equate to more tax savings for the employer so the employer is often encouraged to contribute

The primary benefit is also tax-related for employees. A participant can typically expect to save 20% to 40% of every dollar put into the plan. [3] The amount that the employee decides to put into the plan must be chosen each year. The "election" amount is deducted from the employee's paycheck automatically for each payroll period.

For example, $25 per pay period is automatically deducted tax-free if an employee elects to have $600 per year deducted from their pay and placed into the plan and the company has 24 pay periods. The money is sent to the plan's third party administrator to be held. It can then be distributed for reimbursement upon request for qualified expenses.

What Expenses Can a Section 125 Plan Cover?

A wide variety of medical and childcare expenses are eligible for reimbursement under a Section 125 plan. Dozens of eligible expenses for medical items and treatments can be reimbursed.

Eligible expenses include acupuncture, treatment for alcoholism, ambulance services, birth control, chiropractic services, dental and doctors' fees, eye exams, fertility treatment, hearing aids, long-term care services, nursing homes, operations, prescription drugs, psychiatric services, sterilization, wigs, and wheelchairs. [4]

There's also a large variety of eligible over-the-counter items. Allergy medicines, cold medicines, contact lens solutions, first-aid kits, pain relievers, pregnancy tests, sleeping aids, and throat lozenges are among the dozens of eligible items.

FAST FACT

Many dual-purpose items are eligible, such as dietary supplements, orthopedic shoes, prenatal vitamins, and sunscreen.

Use It or Lose It

Section 125 plans do state that you must use any remaining funds in the account by the end of the year or the money is forfeited to your employer. [5] But a carryover provision that was implemented in 2013 does allow plan participants to extend up to $500 of unused funds from one year to the next. [6]

your Section 125 plan. You notice that you have $100 remaining in the account at the end of the year. You've already saved $240 on taxes ($1,000 x 24%) if you're in the 24% marginal tax bracket. Forfeiting the $100 means that you still have a net benefit of $140.

> **Important:** Division EE of the Consolidated Appropriations Act of 2021 offers more discretion for FSA and dependent care assistance programs. The act allows for more flexibility when it comes to carrying over unused balances from plan years 2020 and 2021, as well as extending permissible grace periods for these plan years. [7]

Setting Up a Section 125 Plan

Setting up a Section 125 plan is straightforward. An employer must provide proper documentation, notify employees, and perform nondiscrimination testing. Section 125 plans must pass three nondiscrimination tests that are designed to determine if the plan discriminates in favor of highly compensated or key employees of the business: eligibility to participate, benefits and contributions, and concentration tests. [5]

Cafeteria plans have different levels of benefits. A premium-only plan (POP) allows employees to pay their portion of insurance on a pretax basis. The flexible spending account (FSA) version allows for out-of-pocket qualified expenses to be paid pre-tax.

The full-blown plan is a consumer-driven healthcare (CDHC) plan. It involves a credit system that the employee can use on a discretionary basis for qualified expenses. Employees can then supplement the CDHC with their own money and use it to buy additional benefits or coverage.

Employers must hire and partner with a qualified Section 125 third party administrator who can provide the most up-to-date documentation for setting up a plan and update the employer on the latest requirements necessary for compliance. Typical third party administrators provide employers with an up-to-date plan document, summary plan descriptions, corporate resolution, customized forms, legal review, attorney opinion letters, discrimination testing, a signatory-ready Form 5500 if required, and employee education.

What Is Included in a Section 125 Plan?

retirement deposits, supplemental life or disability insurance, Health Savings Accounts, and various medical or dependent care expenses.

What Is a Section 125 Premium-Only Plan?

A Section 125 premium-only plan (POP) is a cafeteria plan that allows employees to pay their health insurance premiums with tax-free dollars. As the name implies, these premiums are the *only* expense that the funds can cover. The premiums can be for employer-sponsored insurance plans or individual health policies. POPs are one of the most common types of Section 125 plans. [8]

Who Isn't Eligible for a Section 125 Plan?

The Section 125 rules specifically prohibit the following individuals from participating in plans:

- Self-employed individuals
- Partners within a partnership
- Shareholders who own more than 2% of a subchapter S corporation [9]

The Bottom Line

A Section 125 plan lets employees set aside insurance premiums and other funds on a pretax basis. This can save workers 20% to 40% in taxes per year but these plans offer employers some tax-saving benefits as well. It can be worth it to suggest that your employer set up such a plan or keep it in mind if you're job hunting so you can potentially hire on with a company that does offer a cafeteria plan.

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