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The Benefits Brief…

Boost Non-Taxable Benefits To Owners And Key Employees

In a quandary about owners and key employees who can't fully participate in cafeteria plans due to nondiscrimination testing? I have been asked over and over how to maximize non-taxable benefits to owners and key/highly compensated employees. The solution may be a simple cafeteria plan.

With a simple cafeteria plan, a company can skip all the applicable nondiscrimination testing requirements associated with today's cafeteria plans, assuming it meets specific requirements.

First let's discuss what constitutes an eligible employer and then move on to the eligibility, participation and contribution requirements. Then, as we go through some examples, you may see how C corporations can provide additional non-taxable benefits to owners and key employees. A simple plan will be a snap for some of your employers. Let's look at the facts.

Eligible Employer

Simple plans are for "small" businesses, i.e., 100 or fewer employees during either of the two years preceding application. If an employer has not been in existence for two years, calculations are based on the average number of individuals reasonably expected to be employed on business days during the current year. Employees must be counted under common ownership rules, part-time, seasonal and leased employees.

Eligible employers that grow to more than 100 employees after establishing a simple plan can retain eligibility until their employee population averages 200 or more. Then, at the end of the plan year, that employer must revert to a regular cafeteria plan with nondiscrimination testing for the subsequent plan year.

IRS regulations prohibit a sole proprietor, member in a partnership, member of an LLC (in most cases) or person owning more than 2 percent of an S corporation from participating in a cafeteria plan, but they may still sponsor a simple plan. Plus these owner/employees can still benefit from the savings on payroll taxes and, in some cases, workers' compensation premiums—and these types of business entities may have key or highly compensated employees who can benefit from a simple plan. Shareholders of regular C corporations may also participate in a simple cafeteria plan.

Eligibility and Participation Rule

Simple plans must allow all employees with at least 1,000 hours of service during the preceding year to participate, with the right to elect any benefit offered.

Some employees may be omitted from participating if they are under the age of 21, have less than one year of service, are covered by a collective bargaining agreement, or are a nonresident alien working outside

Chart 1
Without a Simple Cafeteria Plan

Owner/ Employee Population	Compen-sation	Election to Cafeteria Plan	FICA Savings	POP Payment to Carrier	2 Percent of Comp	6 Percent of Comp Participants	Two X Election
2 Owners	$400,000	$19,600	$ 284	$ 9,600	$ 8,000	$24,000	$39,200
6 Non-Highly Compensated Employees Participating	300,000	26,000	1,990	18,000	6,000	18,000	52,000
3 Non-Highly Compensated Employees Not Participating	150,000	—	—	—	3,000	—	—
Total	$850,000	$45,600	$2,274	$27,600	$17,000	$42,000	$91,200

With a Simple Cafeteria Plan

Owner/ Employee Population	Compen-sation	Election (Increased by POP Portion	Required Contribution 6 Percent of Comp	FICA Savings	Previous POP Payment	Net Additional Funds
2 Owners	$400,000	$29,200	$24,000	$ 75	$ 9,600	$14,325
6 Non-Highly Compensated Employees Participating	300,000	44,000	18,000	1,990	18,000	($1,990)
3 Non-Highly Compensate Employees Not Participating	150,000	—	—	—	—	—
Total	$850,000	$73,200	$42,000	$2,065	$27,600	$12,335

of the United States whose income did not come from a U.S. source.

Required Employer Contributions

Required employer contributions can be delivered through the plan by either of two methods.

Non-Elective. Contributions must be equal to a uniform percentage of not less than 2 percent of an employee's compensation for the plan year. This amount is made available to all eligible employees, even if they do not make salary deductions.

Matching. Contributions may be the lesser of twice the amount of an employee's salary reduction contributions or 6 percent of an employee's compensation for the plan year.

Employer contributions must be available to be used for any qualified benefit offered through the plan, but cash need not be an option for these required employer contributions. Employer contributions cannot be made to highly compensated or key employees at a greater rate than to rank-and-file employees.

Non-Discrimination Tests

What does all this "buy" an employer? In addition to some serious payroll tax savings, there's no more complicated and confusing nondiscrimination testing associated with offering a regular cafeteria plan. Two of those most frequently failed tests are the dependent care 55 percent concentration test and the overall 25 percent concentration test. Let's work through one case example to see how the 25 percent concentration tests can affect a regular cafeteria plan and how the implementation of a simple cafeteria plan can benefit owners and key employees.

Let's assume there are two owners and nine other employees. The owners elect $19,600 and six non-highly compensated employees elect $26,000 for a total of $45,600 in salary reductions. These amounts include premiums for employer-provided health coverage, dependent care and a health FSA.

This scenario would not pass the 25 percent concentration test because $19,600 divided by $45,600 equals 43 percent of total benefits going to key employees. In order to pass, the owners would have to reduce their elections to approximately $8,700. In addition, the plan would not pass all of the dependent care discrimination tests; thus, one owner would lose the $5,000 pretax benefit from the dependent care portion of the plan.

By establishing a simple cafeteria plan, there are no required discrimination tests and business owners are able to take advantage of substantial employer contributions.

Chart 1 (on page 44) illustrates the contribution options this employer may pursue. In this example the employer could choose between contributing 2 percent of compensation to the simple plan for all eligible employees, or contributing an amount equal to 6 percent of compensation for participating employees.

In addition, this employer previously paid half of the group health insurance premiums. Employer contributions to the simple cafeteria plan will take the place of employer-paid group health insurance premiums in the amount of $27,600. And don't forget, if participants don't spend all their money, it can be forfeited back to the employer to offset administrative expenses. Thus, by forfeiting unused contributions, the employer's net costs could be reduced further. In the example shown in Chart 1, a contribution of 6 percent of compensation to a simple cafeteria plan would provide the two owners with $24,000 and the six non-highly compensated employees with $18,000. The net outlay of $12,335 is a drastic reduction, considering the premiums they used to pay—and $24,000 goes directly to the owners.

It's All in the Numbers

For small or family-owned C corporation businesses, a simple cafeteria plan may be just the ticket to maximize benefits to owners and key employees.

For larger companies a simple plan may make sense in order to pass all the nondiscrimination tests and preserve non-taxable benefits to owners, key and highly compensated employees.

The information contained in this article is not intended to be legal, accounting, or other professional advice. We assume no liability whatsoever in connection with its use, nor are these comments directed to specific situations.