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Benefit Strategies

Employers rely on you for more than just information about your particular product or service. They expect to get the scoop on new products and the delivery systems to make them happen.

I'm sure these phrases or attitudes sound familiar. "What's new?" "By the way—save me money." "And, while you're at it, explain all this benefit 'stuff' to my employees."

There are a lot of questions to answer and big requests to fill; and while cafeteria plans have been around a long time, they can still be the answer to some of your clients' tallest orders.

Cafeteria plans, or flexible benefits accounts, were created by the Revenue Act of 1978 and provide one way for employers to deliver nontaxable benefits to employees. However, to have a true cafeteria plan, the employer must offer at least one taxable benefit and one nontaxable benefit. Does this mean that employers must "give away cash"? Not at all. In most instances the taxable, or cash, benefit provided through cafeteria plans is merely the employee's current compensation.

That's more or less the IRS definition of a Section 125 cafeteria plan. With that information out of the way, we can now get into the more practical matter of explaining the type of benefits that can be offered through a cafeteria plan and the expenses that can be reimbursed through these benefits.

Premium Only Plans

Sometimes called POPs, this portion of a cafeteria plan allows employees to redirect a portion of their salaries in order to pay for employer-sponsored insurance policies with pretax dollars. POPs are not considered flexible spending accounts (FSAs) because employees are generally not required to submit claims in order to reimburse their premium expenses. The employer is the conduit for paying the salary redirections straight to the various insurance carriers.

POPs can include premiums paid for policies that provide payment for health insurance; prescription drugs; replacement of lost or damaged contact lenses or hearing aids; long and short term disability (if disability insurance is paid on a pretax basis, any benefits received are taxable to the employee); accidental death and dismemberment; employer sponsored group term life insurance ($50,000 coverage limitation, including any employer-provided coverage and no dependent coverage, even if *de minimus*); dental care; and vision care.

The POP benefit *cannot* include premiums paid for whole life insurance policies, return of premium products or long term care policies.

Flexible Spending Accounts

Other benefits that may be offered through a cafeteria plan are commonly called flexible spending account benefits, or FSAs. This means that employee salary redirections are held by the employer for future reimbursements. The employee must incur an eligible expense and submit a claim for reimbursement. Once a claim is adjudicated and approved for payment, untaxed dollars are returned to the employee to reimburse him for expenses incurred.

FSA benefits that can be reimbursed from the cafeteria plan include medical expenses, dependent or child daycare expenses and adoption expenses. A cafeteria plan can even offer employees a way to buy and sell vacation days, make contributions to 401(k) plans, or fund their health savings accounts.

Medical Benefit

The medical benefit offered through a cafeteria plan is routinely called a health flexible spending account (Health FSA). This sounds simple enough, but what exactly does the IRS consider to be a "medical expense"?

We'll get the "IRS language" out of the way first. "Eligible medical expenses include amounts paid for the diagnosis, cure, mitigation, treatment or prevention of disease and for treatments affecting any part of or function of the body."

These expenses are typically what we think of as normal medical charges. You know, the trips to the doctor, dentist or optometrist. Medical care comes in three flavors—fees, prescriptions and medical equipment.

Fees include insurance co-payments and deductibles; physician fees (e.g., office visits); hospital bills; most dental expenses; vision expenses; and diagnostic fees.

Vision expenses can include surgery to correct vision problems. These procedures are sometimes called LASIK or laser surgery.

Prescriptions are anything that is ingested, injected or rubbed on. These items must be drugs that can only be obtained with a prescription.

Over-the-counter drugs such as aspirin and decongestants pass the test as medically necessary and may be reimbursed from the medical benefit.

But what about herbs and vitamins? These types of items are considered for the general health of a participant. Claims for herbs or vitamins must be recommended by a doctor.

Medical equipment includes contact lenses and the solution to maintain them, dentures, eyeglasses, and hearing devices and batteries.

Be careful when including big-ticket items in a cafeteria plan, such as an elevator installed in a home. It still has to be associated with a specific disease, and the cost of improvements that increase the value of the property may only be partly included as a medical expense. This type of expenditure is a *capital expense.* The cost of the improvement is reduced by the increase in the value of the property.

What about a phone especially equipped for the hearing impaired? Well, only the *excess cost* would be considered a medical expense. Excess cost means the cost of the unique phone over and above the cost of a similar phone without the special equipment.

The medical benefit *cannot* reimburse expenses paid for cosmetic surgery and procedures; dental bleaching; marriage counseling; over-the-counter drugs and medications (including vitamins and aspirin not prescribed by a physician, and stop-smoking patches, medications and gums); weight loss programs for general health or appearance; premiums the employee or spouse pay for insurance coverage (payroll-deducted premiums sponsored by the employer are eligible under the premium only plan).

Dependent Daycare Benefit

This benefit reimburses the participant for daycare expenses. The expenses must be incurred for an eligible child or adult and must allow the participant and the spouse, if he is married, to work or look for work.

Eligible daycare expenses include nanny expenses for services provided inside the home (eligible to the extent they are attributable to dependent care expenses and expenses of incidental household services); dependent care expenses incurred for services outside the home (provided they are incurred for the care of a qualifying dependent that regularly spends at least eight hours per day in the home); registration fees to a daycare facility as long as the fees are allocable to actual care and not described as a materials or other fee. In addition, nursery school expenses are eligible, even if the school also furnishes lunch and educational services. Expenses paid to a relative (e.g., child, parent or grandparent of participant) are eligible. However, the relative cannot be under age 19 or a tax dependent of the participant. FICA and FUTA payroll taxes of daycare providers are eligible.

Reimbursement for dependent daycare may not exceed the smaller of the following limits: the maximum allowed under the plan; $5,000 if filing a joint tax return and $2,500 if separate returns are filed; household taxable compensation after all compensation reduction elections; and if married, the spouse's actual or deemed earned income.

The dependent daycare benefit *cannot* reimburse expenses paid for kindergarten fees (almost always considered an educational expense) and elementary school expenses for a child in first grade or higher; food, transportation and incidental expenses (diapers, activities, etc.) are not eligible if charged separately from dependent care expenses; expenses paid to a housekeeper, maid, cook, etc., except where incidental to child or dependent adult care.

This benefit will get more notice as baby boomers age and have responsibility for their parents. The older adult must be a dependent of the participant, be incapable of self care, and live with the participant at least eight hours per day.

A dependent care credit is available that can be included in a family's tax return filing. Whether to participate in the daycare portion of a cafeteria plan or to take the tax credit depends on the individual's filing status, number of dependents and annual daycare expenses.

Adoption Assistance Benefit

The adoption assistance benefit allows employees to redirect a portion of their salary to pay for most expenses associated with a legal adoption. The current IRS limit on expenses that can be turned in for any one adoption is $10,630. This figure will ordinarily be indexed upward each year. The credit is available to everyone, but will reduce as family income levels increase.

Eligible adoption expenses include reasonable and necessary legal adoption fees; court costs; attorney fees; and other expenses which are directly related to, and the principal purpose of which is for, the legal adoption of an eligible child.

An additional rule to keep in mind for adoption benefits is the taxation of the employee contribution. Most benefits elected and payroll deducted through a cafeteria plan are not subject to federal, social security and most state taxes. However, the contributions made to the adoption assistance portion of the plan *will be* subject to the 7.65 percent social security, or FICA, taxes. That also means the employer will have to pay his matching portion of the FICA taxes.

The adoption assistance benefit *cannot* reimburse the following expenses: adoption of a child belonging to the participant's spouse; illegal adoption fees; surrogate parenting arrangements; or legal adoption expenses for which another deduction or credit is allowed.

Keep in mind, this is an introductory course. You or your clients should not have to be cafeteria plan experts. You or your employers sponsoring a cafeteria plan should be able to call the plan administrator with difficult questions and be reasonably assured of receiving a correct answer.

In the economic times of today, it's important to keep employers enlightened on available benefit strategies to help them strengthen and develop their businesses.

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