

# SECTION 125 — PRE-TAX “CAFETERIA” PLAN

One of the most underrated and underused employee benefits available for small businesses today is outlined in section 125 of the U.S. tax code. A section 125 or "cafeteria" plan allows employees to withhold a portion of their pre-tax salary to cover certain medical or child-care expenses. Because these benefits are free from federal and state income taxes, an employee's taxable income is reduced, which increases their take-home pay. Because the pre-tax benefits aren't subject to federal social security withholding taxes, employers win by not having to pay FICA — or workers' comp premiums — on those dollars and employees win by not having to pay FICA, federal and most state withholding taxes.

## UNDER A CAFETERIA PLAN, EMPLOYEES CAN TAKE ADVANTAGE OF THREE SPECIFIC FLEXIBLE BENEFITS:

### 1. Pre-tax health insurance premium deductions, also known as a Premium Only Plan (POP)

POP plans allow employees to elect to withhold a portion of their pre-tax salary to pay for their premium contribution for most employer-sponsored health and welfare benefit plans.



### 2. Dependent care flexible spending account (FSA)

The dependent care FSA is an attractive benefit for employees who pay for child-care or long-term care for their parents. Many employees don't take advantage of this benefit and may be unaware of the significant tax savings. Employees may hold back as much as \$5,000 annually of their pre-tax salary for dependent care expenses, which include expenses they pay while they work, look for work or attend school full time. Qualified dependent care expenses may include — but are not limited to — the care of a child under the age of 13, summer day camps, long-term care for parents, and care for a disabled spouse or a dependent incapable of caring for himself.



### 3. Out-of-pocket unreimbursed medical expenses, also known as flexible spending accounts (FSAs)

An FSA allows an employee to fund certain medical expenses on a pre-tax basis through salary reduction to pay for out-of-pocket expenses that aren't covered by insurance (for example, annual deductibles, office co-payments, prescriptions, eye care, over-the-counter drugs and dental care, including orthodontia). The average working employee in America spends more than \$1,000 annually on these types of benefits. By participating in a FSA, an employee's taxable income is reduced, which increases the amount of their pay they take home.

### WHAT ARE PRE-TAX CONTRIBUTIONS?

Contributions you make to an FSA are made on a pre-tax basis. This means your contributions are taken from your paycheck before federal, FICA, and most state and local taxes are withheld. You also get an immediate advantage from contributing pre-tax dollars right in your paycheck. Each pre-tax dollar you contribute lowers your current taxable income, so you end up reducing the current federal income tax and FICA tax that you pay. In most cases, you'll also pay lower state and local income taxes. Although pre-tax contributions reduce your current income for tax purposes, they don't lower it for determining your company benefits that are based on pay.

### DO I NEED TO ENROLL TO PARTICIPATE IN AN FSA?

Yes, you must enroll if you want to participate in an FSA. To continue participating after your initial enrollment, most plans require you to re-enroll each year during open enrollment. Your elections do not automatically continue from one year to the next.

### HOW DO I CONTRIBUTE TO AN FSA?

You fund your FSA(s) with pre-tax dollars that are deducted from your pay in equal installments throughout the year. Your plan will define minimum and maximum contribution amounts.

### HOW DO I ESTIMATE MY HEALTH CARE FSA CONTRIBUTIONS?

To estimate your future expenses, first review similar expenses you've had over the last couple of years. Also consider any eligible health care expenses (medical, dental, vision or hearing) that you expect may occur during the year.

It's important to estimate your expenses carefully before you decide how much you want to contribute to the health care FSA each year. Be conservative in your estimate since you lose any balance that isn't used by the claims filing deadline. On the other hand, if your expenses dramatically exceed the amount you contribute to the FSA, you miss out on some tax savings.



### WHAT ARE ELIGIBLE EXPENSES FOR THE HEALTH CARE FSA?

An eligible expense for the health care FSA must be for a service that is:

- ✓ Medically necessary
- ✓ For you, your lawful spouse, or anyone you claim as a dependent on your tax return
- ✓ Not reimbursed or is only partially reimbursed elsewhere, such as through an insurance plan covering you or your spouse
- ✓ Considered an allowable expense by the IRS

In addition, these rules apply to the health care FSA:

- ✓ You cannot claim reimbursed expenses on your tax return as well
- ✓ If both you and your spouse are eligible for a health care FSA, you can each contribute up to the maximum in separate accounts

### WHEN MAY I CHANGE MY FSA CONTRIBUTIONS?

You may change your FSA contributions each year during open enrollment. Your plan may also allow you to change your contributions mid-year if you have a change such as marriage or becoming a parent.

### HOW DO I FILE A HEALTH CARE FSA CLAIM?

To file a health care FSA claim:

- ✓ Obtain a claim form
- ✓ If expenses were partially covered by you or your eligible dependents' medical, dental, vision or hearing plan, attach the Explanation of Benefits (EOB) you received from the health care company to your claim form
- ✓ If expenses are not covered by insurance, include an itemized bill or receipt from the provider showing the:
  - Patient's name,
  - Name of the provider,
  - Type of service or product provided,
  - Date the expense was incurred,
  - Amount of the expense, and
  - Provider's signature
- ✓ Submit the completed claim form and documentation as instructed on the form



### WHEN AM I REIMBURSED FOR HEALTH CARE FSA EXPENSES?

When you file a claim, you are reimbursed for the amount of eligible expenses in your claim up to the amount of your annual election, minus any previous reimbursements. Here's an example. Sue elects to set aside \$480 each calendar year (\$40 a month) for her health care FSA. In January, she files a claim for a \$50 prescription and is reimbursed for the \$50. In February she buys trifocal glasses and has a surgical procedure. Her share of the February expenses is \$600 and she files a claim for \$600. Because her annual account balance is \$430 (\$480 total minus the \$50 already reimbursed) she is reimbursed for \$430. Her account is now empty for the rest of the year.

### WHAT IF I HAVE AN EXPENSE LATE IN THE YEAR, AND DON'T GET THE BILL UNTIL THE FOLLOWING YEAR? HOW DO I FILE THE CLAIM?

An FSA claim is eligible for reimbursement in the year in which it is incurred. An eligible expense is considered incurred on the date the service or treatment is provided, not on the day you pay for it. If the service or treatment will extend beyond the end of the year, only expenses incurred during the plan year for which you are contributing to your account will be eligible for reimbursement in that plan year. If you have FSA accounts in both years, you will file part of the claim against one year's account and part against the next year's account.



**WHAT HAPPENS TO CONTRIBUTIONS LEFT IN MY FSA AT THE END OF THE YEAR BECAUSE I DIDN'T FILE CLAIMS AGAINST THEM?**

Because of the favorable tax treatment provided by the FSA, government regulations require that the money you contribute to your FSA only be used for eligible expenses incurred during that same year and 2 1/2 months into the next year providing that your employer plan documents have provided for that 2 1/2 month extension. However, you may submit claims for a given year up to your plan's claims filing deadline which is usually 90 days after the plan year plus a 2 1/2 month extension in the following year. Any money left in your account(s) after the claims filing deadline is forfeited. You cannot use one year's contributions for the next year's expenses.

Here's an example. Joe enrolls for an FSA and elects to set aside \$500 a year. By the claims filing deadline of the following year, Joe has only filed claims for \$450. Joe forfeits the \$50 difference. He does not, however, lose the tax savings on that \$50.

**WHAT HAPPENS TO MY HEALTH CARE FSA ACCOUNT IF I STOP WORKING FOR THE COMPANY BEFORE THE END OF THE YEAR?**

You may submit claims to your FSA account for eligible expenses incurred before your participation ended, up until the claims filing deadline in the following year. Larger companies are required by the Consolidated Omnibus Budget Reconciliation Act (COBRA) to allow you to continue participation in your health care FSA for a limited period of time through COBRA. However, if you are eligible for COBRA continuation, your future contributions will be in after-tax dollars and you may need to pay a 2% administrative fee. If you elect to continue your participation, you may submit claims for expenses incurred for as long as you participate in the health care FSA.

**WHAT HAPPENS TO MY FSA IF I DIE DURING THE YEAR?**

Your contributions to your FSA stop. However, until the claims filing deadline, your survivors can continue to file eligible expenses you incurred before your death.

**MY COMPANY OFFERS BOTH A HEALTH CARE FSA AND A DEPENDENT CARE REIMBURSEMENT ACCOUNT AND I PARTICIPATE IN BOTH. CAN I SHIFT MONEY BETWEEN THE TWO ACCOUNTS?**

No. IRS regulations require the accounts to operate separately. You cannot use your health care FSA for eligible dependent care expenses, or the reverse.



**For more information, please e-mail us at [info@hrefile.com](mailto:info@hrefile.com) or visit us at [www.hrefile.com](http://www.hrefile.com).**



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